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IN THE

Supreme Court of the United States

October Term, 1977

No. 77-727

FINLEY, KUMBLE, WAGNER, HEINE, UNDERBERG & GRUTMAN, a Partnership (formerly known as Finley, Kumble, Underberg, Persky & Roth and Finley, Kumble, Heine, Underberg & Grutman),

Petitioner,

against

CHARLES GROSS, MABEL BLEICH, GROSS & Co., and JEANNE DONOGHUE,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioner, Finley, Kumble, Wagner, Heine, Underberg & Grutman ("Finley, Kumble"), additional defendant on counterclaims-appellant-cross-appellee below, requests that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered on August 24, 1977.

Opinions Below

The opinion of the Court of Appeals is not yet reported and appears as Appendix A to this petition. The post-trial opinion of the District Court is not reported and appears as Appendix B to this petition. The pre-trial opinion of the District Court is reported at 365 F. Supp. 1364 and appears as Appendix C to this petition.

Jurisdiction

The judgment of the Court of Appeals was entered on August 24, 1977. The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

Questions Presented

This case raises important and recurring questions concerning the scope of federal ancillary jurisdiction.

The decision below extended the reach of ancillary jurisdiction by an expansionary interpretation of the compulsory counterclaim rule. As a result of that interpretation, the courts below were embroiled for six years in litigation of non-federal claims involving non-diverse parties. As a further result of that interpretation, petitioner, who was a stranger to the action when it began, was brought into federal court to answer state law counterclaims which lacked any independent jurisdictional predicate.

Rule 13(a) defines as "compulsory" a counterclaim which "arises out of the transaction or occurrence which is

the subject matter of the opposing party's claim." A counterclaim meeting that description must be pleaded or it is thereafter barred. Under the doctrine of ancillary jurisdiction, the federal courts have been held to have power to adjudicate such a counterclaim even if it presents purely state claims and there is no diversity of citizenship among the parties. *United States* v. *Heywood-Robinson Company,* 430 F.2d 1077 (2d Cir. 1970), *cert. denied,* 400 U.S. 1021 (1971); *Aetna Ins. Co.* v. *Chicago R.I.&P.R. Co.,* 229 F.2d 584 (10th Cir. 1956). *See also, Moore* v. *New York Cotton Exchange,* 270 U.S. 593 (1926).

On the other hand, a counterclaim not meeting the test of Rule 13(a) is deemed to be "permissive." The defendant does not have to plead it, and if pleaded, the Court lacks power to hear it unless the counterclaim itself raises a federal question or involves parties with diverse citizenship. *Sue & Sam Mfg. Co.* v. *B-L-S Constr. Co.,* 538 F.2d 1048 (4th Cir. 1976); *Pipeliners Local Union No. 798, Tulsa Okla.* v. *Ellerd,* 503 F.2d 1193 (10th Cir. 1974); *United States* v. *Heywood-Robinson Company,* 430 F.2d 1077 (2d Cir. 1970), *cert. denied,* 400 U.S. 1021 (1971).

Here, the Second Circuit adopted a construction of Rule 13(a) which ignores the language and undermines the purpose of the rule, and removes virtually all restrictions on the federal courts' ancillary jurisdiction. The Court did not rely on any temporal, evidentiary, factual or legal relationship between the issues in the complaint and those in the counterclaims. There was no such relationship. Instead, it found a sufficient jurisdictional basis, for purposes of Rule 13(a), in a linkage between the counterclaims and certain defenses which defendants themselves pleaded in

the answer. On that basis, it sanctioned a lengthy federal trial of non-diverse state counterclaims asserted not only against the plaintiff but also against 19 additional third parties who were newly brought into the action.

No other Circuit has held a link between a counterclaim and a defense to be a sufficient nexus for purposes of Rule 13(a). Nothing in the language of the rule speaks of defenses. No policy of judicial economy justifies reaching out for such unrelated state counterclaims, which overwhelmed the simple claims in the complaint and greatly complicated and expanded the litigation below.

The issues presented by this case have a wide impact on the day-to-day functioning of the federal courts. The decision below subjects these courts to new burdens and involves them increasingly in areas constitutionally reserved to the states. There is a need for this Court to speak to these issues, which it has never squarely addressed in the 40 years since Rule 13(a) was adopted.

Insofar as jurisdiction was extended to petitioner and other third parties, this case also presents, in the context of ancillary jurisdiction, the "subtle and complex question with far reaching implications" which this Court grappled with last year in the context of pendent jurisdiction. In *Aldinger* v. *Howard,* 427 U.S. 1 (1976), this Court found limits on the power of federal courts to exercise pendent jurisdiction over third parties not named as defendants to the claim-in-chief. This case is an opportunity to extend the policy of *Aldinger* to actions involving the more frequently invoked doctrine of ancillary jurisdiction.

This petition thus presents the following questions for review:

1. Are non-federal counterclaims "compulsory," regardless of their relation to the plaintiff's claims, simply because they relate to defenses that the defendant chooses to assert in response to those claims?

2. Should the ancillary jurisdiction of the federal courts be extended to non-federal counterclaims, involving non-diverse parties, where the claims and counterclaims involve different issues, different evidence, different time frames, and substantially different parties?

3. Do the federal courts have jurisdiction over non-federal counterclaims, involving non-diverse parties, asserted against third party counterclaim defendants who were strangers to the original action?

Rule Involved

Rule 13(a) and (b) of the Federal Rules of Civil Procedure provides:

RULE 13

COUNTERCLAIM AND CROSS-CLAIM

(a) Compulsory Counterclaims. A pleading shall state as a counterclaim any claim which at the time of serving the pleading the pleader has against any opposing party, if it arises out of the transaction or occurrence that is the subject matter of the opposing party's claim and does not require for its adjudication the presence of third parties of whom the court cannot acquire jurisdiction. But the pleader need not state

the claim if (1) at the time the action was commenced the claim was the subject of another pending action, or (2) the opposing party brought suit upon his claim by attachment or other process by which the court did not acquire jurisdiction to render a personal judgment on that claim, and the pleader is not stating any counterclaim under this Rule 13.

(b) Permissive Counterclaims. A pleading may state as a counterclaim any claim against an opposing party not arising out of the transaction or occurrence that is the subject matter of the opposing party's claim.

Statement of the Case

A. The Claim

This action began in 1971 as a very simple federal case.* It presented, by assignment to plaintiff, the claims of Charles and Mary Buckley, former customers of the brokerage firm of Charles Gross & Co. The complaint alleged that the brokerage firm, in the period 1962-1966, encouraged or permitted excessive trading in the Buckleys' accounts. (A. 15a)** This improper practice, designed to generate unconscionable commissions, is commonly called "churning."

Churning violates the federal securities laws.† The complaint asserted those federal claims and, based on the

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* Jurisdiction was predicated on 15 U.S.C. §77(v)(a) and 15 U.S.C. §78(a) (1970) and the doctrine of pendent jurisdiction.

** Citations refer to the appendices found at the conclusion of this Petition.

† Churning has been held to violate the Securities Exchange Act of 1934 and Rule 10(b)(5) for which a private cause of action will lie. *See e.g.*, Ruskay v. Waddel, 552 F.2d 392, 393 n.2 (2d Cir. 1977); Carras v. Burns, 516 F.2d 251, 258 (4th Cir. 1975).

identical allegations, a claim of common law fraud. Named as defendants were the brokerage firm; its general partner, Charles Gross; and a limited partner, Mabel Bleich. Suing as plaintiff was Newburger, Loeb & Co., Inc. ("the Corporation"), which acquired the Buckley claim by assignment in 1971.

The complaint thus raised narrow issues frequently litigated in federal court under the securities laws: What was the nature and extent of trading in the Buckleys' accounts in 1962-1966? Who effectively exercised control over the accounts—the dealer or the customer? Who initiated the various transactions in the accounts? Was the customer sufficiently sophisticated to evaluate the broker's advice? So narrow and commonplace were these questions that the Court of Appeals devoted barely three pages of its 50-page printed opinion to disposing of them.

B. The Counterclaims

It was the responsive pleadings which transmuted this simple federal case, involving four parties, into a cumbersome, protracted litigation of more than a dozen state claims involving two dozen non-diverse parties—most of whom had nothing to do with the original dispute. Defendants Gross and Bleich—and their colleague, one Jeanne Donoghue—were engaged in a totally unrelated controversy with various individuals and entities connected with Newburger, Loeb & Co. ("the Partnership"), assignor of the Buckley claims to the Corporation. They seized on the Buckley churning complaint as a vehicle for bringing this state law controversy into federal court.

The controversy arose out of the severe economic woes which afflicted the Partnership, a Wall Street investment

and brokerage firm, during the "back office crunch" in the stock market in 1970. Gross had been a general partner—indeed, the managing partner—of the Partnership. However, the firm did not prosper under his direction, and he withdrew. In the relevant period, he was a "withdrawn general partner" whose capital remained at risk with the firm for one year. Bleich and Donoghue were limited partners. (A. 6a-7a)

In late 1970, the New York Stock Exchange threatened the Partnership with immediate suspension unless its impaired capital condition was corrected. The most significant step taken by the Partnership to solve its financial problem was the proposed reorganization of the Partnership into a new Corporation, a step which would (and did) attract new capital. (A. 8a)

Gross and his allies, Bleich and Donoghue, ("the Gross faction") opposed this transaction; everyone else supported it. In the ensuing hard bargaining, it was found below, the Gross faction was threatened and pressured in an effort to compel its consent. A principal element of this effort, it was found below, was the threat to bring "baseless" litigation against the Gross faction—including the Buckley claims, which the Partnership acquired in 1970. The effort failed; the Gross faction witheld consent. (A. 8a-9a)

Nevertheless, the transaction went forward and was closed on February 11, 1971. The Partnership's assets, including the Gross faction's capital, were transferred to the Corporation. Among the many assets transferred at the same time was the Buckley claim. The Gross faction

contended that these actions constituted a common law conspiracy to injure them, a breach of fiduciary duty, and a violation of New York Partnership Law §98.* (A. 15a-16a)

This controversy, of course, had nothing to do with the issue of whether unlawful churning occurred in the Buckleys' accounts in 1962-66. The controversy did not raise federal questions. Nor was there diversity of citizenship among the parties to the controversy. Nevertheless, this controversy became the centerpiece of the litigation below, totally engulfing the Corporation's simple churning claims.

The controversy was propelled into federal court by the following procedural maneuvers:

First: Donoghue, who was not a party to the churning claims pleaded in the complaint, thrust herself into the action as a volunteer defendant. That enabled her to counterclaim.

Second: Gross, Bleich and Donoghue alleged, as defenses to the complaint, that the very acquisition of the Buckley claim and its assertion in this lawsuit were tortious, and that the assignment of the claim to the Corporation—as part of the 1971 reorganization—was unlawful.**

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* As construed below, this state statute precluded the reorganization in the absence of consent by Bleich and Donoghue. Gross, as a withdrawn general partner, had no standing to block the transaction. (A.36a-38a)

** The Second Circuit described the defenses as follows:

> Essentially, the defendants asserted two defenses to the Corporation's churning claims. First, they contended that the February 11 transfer, which included the transfer of the Buckley claim from the Partnership to the Corporation, was ineffective because conducted in violation of New York Partnership Law §98; ac-

(footnote continued on next page)

Third: Gross, Bleich and Donoghue asserted 8 state law counterclaims dealing with the 1971 reorganization and its aftermath.*

Fourth: These counterclaims were asserted against not only the plaintiff Corporation but also 16 parties who were strangers to the case-in-chief. These newly added parties were designated as "additional defendants on counterclaims."

Fifth: Nine months later, in an amended answer, the Gross faction asserted these same counterclaims against three additional strangers—petitioner Finley, Kumble, a law firm which served as counsel to the Corporation, its partner in charge of the matter, and the house counsel to the Partnership. Finley, Kumble ultimately became the principal target of the counterclaimants, the focus of the

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cordingly, they contended that the Corporation could not press the Buckley claim because it did not own it. Second, the defendants claimed that the Corporation was estopped from asserting the claim because it was brought as part of a conspiracy against them in violation of the fiduciary duties owed to them; thus, the defendants alleged, *inter alia*, that the Buckley claim was taken by the Partnership in bad faith for the sole purpose of creating a colorable claim against them, that the transfer of assets was induced by "fraudulent special consideration" as part of a plot by Kayne, Muh and Risher to gain control of the Partnership's assets, and that the transfer itself was a violation of fiduciary duty. (A. 29a)

* Buried in the voluminous pleadings in this case was a final counterclaim—the ninth—purporting to assert a violation of the federal antitrust laws on behalf only of Gross. So devoid of substance was this counterclaim that the District Court dismissed it in a footnote (C. 77a, n.33); the Court of Appeals affirmed, finding "no support in the record for Gross' claim." Neither lower court regarded this claim as a basis for federal pendent jurisdiction over the other counterclaims because the common nucleus of operative fact required by *Gibbs* v. *United Mine Workers*, 383 U.S. 715 (1966) was lacking. (A. 33a)

District Court's opinion, and the source of funds to which the Gross faction looked to satisfy the judgment.

Sixth: The plaintiff Corporation, asserted what can only be characterized as "counter-counterclaims" against Gross. These six new state law claims related neither to the churning of the Buckleys' accounts in 1962-66 nor to the reorganization of 1971; rather, they dealt with alleged misfeasance by Gross during his tenure as managing partner of the Partnership in 1970. (A. 15a-17a; B. 58a-59a)

C. Trial and Decisions on the Merits

The case was tried before the United States District Court for the Southern District of New York in 1975. The trial consumed six weeks of court time and generated a record exceeding 6,000 pages, the great bulk thereof devoted to the counterclaims. Although much of the trial was conducted before a jury, the jury became "restive" as the proceedings droned on; ultimately it was excused, and the case was decided by the Court. (B. 57a)

After a year of deliberation, the District Court rendered its opinion. Quickly rejecting the churning claims, the court devoted its major attention to the counterclaims. It found violations of New York law with respect to three of them.* (B. 71a) Accordingly, it entered judgment against the plaintiff Corporation and 17 of the additional defendants on the counterclaims, including petitioner. With interest and costs, the judgment came to approximately $1,000,000.

* Five of the nine counterclaims had been dismissed before trial, and one was rejected in the District Court's post-trial decision.

On appeal, the Second Circuit affirmed with respect to the three non-federal counterclaims. In doing so, it concededly resolved a novel question of New York law: the scope of fiduciary obligations under the New York Partnership Laws. (A. 48a) By rejecting petitioner's contention that it could not be held liable to defendants for acts in its role as counsel to the plaintiff, the Court necessarily decided a further novel question of New York law. (A. 48a-49a) The Court, however, reversed approximately 25% of the judgment and remanded the balance of the case to the District Court for a redetermination of damages. (A. 50a-52a)*

D. Decision Below on Jurisdictional Issues

The three counterclaims which survived, and to which this petition is addressed, asserted the following: (a) the reorganization violated N.Y. Partnership Law §98 because it was consummated without the consent of Bleich and Donoghue; (b) the transfer of assets to the Corporation was a breach of fiduciary obligation; and (c) the events of 1970 and 1971 leading up to the reorganization constituted a conspiracy to injure the Gross faction and force their consent to the reorganization. (A. 15a-16a)

As the lower courts recognized, these counterclaims did not involve federal questions and there was no diversity of citizenship among the parties, most of whom were residents of New York. Thus, there was jurisdiction over these counterclaims only if they were compulsory under Rule 13(a) and within the Court's ancillary jurisdiction. (A.

* The District Court declined to stay further proceedings on damages pending this petition, and those proceedings have gone forward.

17a, 26a-27a) The key to the jurisdictional issue, therefore, was whether the counterclaims "arose out of the same transaction or occurrence" as the Corporation's churning claim and were covered by Rule 13(a).*

The Second Circuit held that the counterclaims were compulsory not because of their relationship to plaintiff's churning claims but because of their relationship to purported defenses to those claims. (A. 26a-27a) The Second Circuit reached this result even though (i) the Rule's language says nothing about defenses; (ii) the defenses in question—that the assignment and assertion of the Buckley claim were unlawful and tortious—dealt with unrelated matters occurring four years after the churning of the Buckley accounts; and (iii) the defensive allegations—although sustained—were treated by the trial and appellate courts only as grounds for affirmative counterclaim relief and not as grounds for defeating the complaint's churning claim.

In short, the defenses were not covered by Rule 13(a), were not related to the claims asserted in the complaint, and were not treated as true defenses. They were simply the vehicle for asserting state law counterclaims against non-diverse parties and strangers to the original action.

In holding that a link between defenses and counterclaims is sufficient to render the counterclaims compulsory, and in reaching out for state counterclaims so remotely connected to the complaint, the Second Circuit significantly

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* Petitioners raised the issue of subject matter jurisdiction by pre-trial motion and on appeal.

expanded the scope of federal jurisdiction and, we submit, committed fundamental error.

Moreover, the Court paid scant attention to the problems created by applying this expansionary jurisdictional doctrine to third parties—parties who had no connection with the case when it was commenced. The Court said in passing that:

> "... further, if a counterclaim is compulsory, the district court's ancillary jurisdiction extends to third parties (in this case the additional defendants) whose presence is required for adjudication of the counterclaim. See *Moor* v. *County of Alameda,* supra, 411 U.S. at 714-15; *United Artists Corp.* v. *Masterpiece Productions,* supra, 221 F.2d at 216-17." (A. 27a)

However, *Moor* was a pendent jurisdiction case and is not authority for this proposition (*supra* at 31). And there is serious doubt as to the vitality of the Second Circuit's own decision in *United Artists,* along with other prior case law, in light of the concern about extending federal jurisdiction to third parties expressed by this Court last year in *Aldinger* v. *Howard,* 427 U.S. 1 (1976). The Second Circuit did not consider the application of *Aldinger* to this issue.

Reasons for Allowance of the Writ

I

Review is needed to correct a misinterpretation of Rule 13(a)—unique to the Second Circuit—which would significantly expand the jurisdiction of federal courts and improperly involve them in litigation of non-diverse state claims.

The conclusion below that defendants were required to assert numerous, unwieldy state claims in response to plaintiff's simple, unrelated churning claims stretches Rule 13(a) to the breaking point. The conclusion that Rule 13(a) embraces counterclaims related to defenses—regardless of their relationship to the complaint—conflicts with the language and frustrates the policy of the Rule. No court has ever so held—except the Second Circuit itself in its previous decision in *Lesnick* v. *Public Industries Corporation,* 144 F.2d 968 (2d Cir. 1944).

On the basis of this novel holding, the District Court was encumbered for several weeks in a trial of purely state claims which, but for this holding, it was powerless to hear, It spent a full year sorting out the rights and liabilities, under state law, of some 24 non-diverse litigants, the vast majority of whom were strangers to the narrow federal controversy before it. The Court of Appeals sanctioned this expenditure of federal judicial resources.

The implications of this holding are obvious and sobering: in the name of judicial economy, already overburdened federal courts will further intrude into areas reserved to the states and become increasingly bogged down

in the litigation of disputes which belong elsewhere. Review is needed to curb this unwarranted expansion of federal jurisdiction and to clarify the compulsory counterclaim doctrine which, despite its importance in the day-to-day workings of the lower courts, has not been squarely addressed by this Court since Rule 13(a) was adopted.

A. The Second Circuit has misinterpreted and significantly expanded Rule 13(a).

In applying the language of Rule 13(a), courts normally determine whether the complaint and counterclaims involve substantially the same time frame, evidence, factual setting, legal issues and the like, and whether adjudication of the complaint would be *res judicata* as to the counterclaims. As the Tenth Circuit said in *Pipeliners Local Union No. 798, Tulsa, Okla.* v. *Ellerd,* 503 F.2d 1193, 1198 (10th Cir. 1974):

> "It has been said that most courts, rather than attempting to define the key terms of Rule 13(a) . . . precisely, have preferred to suggest standards by which the compulsory or permissive nature of specific counterclaims may be determined: (1) Are the issues of fact and law raised by the claim and counterclaim largely the same? (2) Would res judicata bar a subsequent suit on defendants' claim absent a compulsory counterclaim rule? (3) Will substantially the same evidence support or refute plaintiffs' claims as well as defendants' counterclaim? and (4) Is there any logical relation between the claim and the counterclaim? See Wright and Miller, Federal Practice and Procedure, Civil §1410, Ch. 4, p. 42 and cases cited. . . ."

These criteria have been cited with approval by courts in other Circuits. *Sue & Sam Mfg. Co.* v. *B-L-S Constr. Co.,*

538 F.2d 1048 (4th Cir. 1976); *Agostine* v. *Sidcon Corp.*, 69 F.R.D. 437 (E.D. Pa. 1975). Even where the Tenth Circuit's formulation is not explicitly invoked, other circuits normally treat these criteria as central to an application of Rule 13(a). *Columbia Plaza Corp.* v. *Security Nat. Bank*, 525 F.2d 620 (D.C. Cir. 1975); *Albright* v. *Gates*, 362 F.2d 928 (9th Cir. 1966); *Great Lakes Rubber Corp.* v. *Herbert Cooper Co.*, 286 F.2d 631, 634 (3d Cir. 1961).

None of these criteria suggests the slightest relationship between the claims and counterclaims asserted here.

First, the issues of fact and law raised by the complaint and the counterclaims are totally disparate. Plaintiff's claims involve the alleged churning by Gross & Co. of the Buckleys' brokerage accounts from April 1962 through August 1966. The claims have nothing to do with the Newburger, Loeb reorganization or any events after 1966, including the assignment of that claim to the Corporation in 1971 or its subsequent assertion by the Corporation.

On the other hand, the counterclaims relate to the transfer of assets, on February 11, 1971, of the Partnership to the Corporation, and the defendants' opposition to that transfer. They concern alleged torts and violations of the N.Y. Partnership Law occurring several years after any transactions which are the subject of the complaint. These issues have nothing whatsoever to do with any events in 1962 through 1966, let alone the events relating to the Buckleys' brokerage accounts. The defenses—that the acquisition and assertion of the Buckley claims in 1971 were unlawful and tortious—do not bear on "the subject matter of [plaintiff's] claim."

Second, a disposition of the complaint would not be *res judicata* of the counterclaims, and vice versa. Nothing illustrates that more clearly than the lower court decisions in this very case. Both the District Court and the Second Circuit rejected the churning claims on the merits, without any reference to the counterclaims. Likewise, in adjudicating the counterclaims, neither court relied on or even mentioned a single finding of fact or conclusion of law used to adjudicate the churning claims. In essence, both the trial and appellate courts issued two separate opinions linked only by the caption.

Third, the evidence on the complaint and the counterclaims was completely different. Just as the decision below was really composed of two decisions, so the trial below was really a succession of two trials—one of the churning claims and the other of defendants' counterclaims. The testimonial and documentary evidence introduced in support of the complaint was not considered on the trial of the counterclaims, and the proof on the counterclaims had no bearing on the claims in the complaint.

But the Second Circuit paid no attention to these matters. Indeed, it made little effort to link the issues in the counterclaims with the issues in the complaint. Instead, it found the counterclaims to be compulsory because of their relationship with the defenses pleaded in the answer.

Thus, although there was no overlap between the claims and the counterclaims, the Second Circuit invoked Rule 13(a) because of "a substantial overlap between the defendants' defenses and their . . . counterclaims." (A. 30a) Although there was no overlapping of proof between the

claims and the counterclaims, the Second Circuit invoked Rule 13(a) because "proof of these defenses was tantamount to establishing defendants' case on their counterclaims." (A. 30a) In sum, the Second Circuit agreed with the District Court's conclusion

> "that defendants' first and second counterclaims were so closely tied to its defenses to the Corporation's claims that they were 'logically related' to those claims and that since the fourth counterclaim asserted the same allegedly wrongful acts, it too should be considered a compulsory counterclaim." (A. 29a)

and affirmed on that basis.

By holding that a link between a counterclaim and a defense is a sufficient nexus to support federal jurisdiction, the Second Circuit rejected the very language of Rule 13(a). The Rule defines a compulsory counterclaim as one "which . . . arises out of the transaction or occurrence that is the subject matter *of the opposing party's claim* . . ." (emphasis supplied). Rule 13(a) does not speak in terms of defenses, and nothing in its language permits the kind of analysis in which the Second Circuit engaged.

The holding below rejects, as well, the policy and the procedural logic inherent in Rule 13(a). When a plaintiff brings a federally cognizable claim, neither the defendant nor the court has any choice about delving into the transactions and occurrences on which it is based. If those same transactions and occurrences—which must be explored in any event—give rise to a non-federal counterclaim, common sense and the interests of judicial economy suggest that both claims be resolved simultaneously.

But a defendant has complete control over his defenses.* The fertile mind of a pleader can devise wholly extraneous defenses which, regardless of their merit, become the hook on which to hang elaborate state counterclaims raising matters the court otherwise would not and could not hear.

That is precisely what happened in this case. Although the defenses were held to be acceptable vehicles for bringing the counterclaims, and the allegations thereof were sustained for purposes of awarding defendants affirmative relief, the lower courts did not regard the defenses as sufficient to defeat the churning claims. On the contrary, both the District Court and the Second Circuit considered and resolved the churning claims on the merits—without ever mentioning the defenses.

The gist of the defenses was that the Buckley claim could not be asserted because it was assigned to plaintiff as part of an illegal transaction and that the plaintiff's assertion of the claim was tortious.** The lower courts con-

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* For that reason, a counterclaim linked to a defense can never be truly "compulsory" as that word is commonly understood. If the defendant, for tactical or procedural reasons, prefers not to assert his counterclaim, he simply refrains from asserting the defense to which it is linked. He is then free to assert his claim in another action. Thus the Second Circuit's holding inverts the concept of Rule 13(a)—that a defendant must assert compulsory counterclaims or be forever barred—and gives the defendant discretion to assert or not to assert compulsory counterclaims.

** The courts below did not rely on the Gross faction's contention that the Corporation's ritualistic one sentence allegation in the complaint that it owned the churning claims, by assignment, provided common legal and factual issues which compelled the Gross faction to assert its counterclaims.

Moreover, the courts below did not rely on the argument that the counterclaims were compulsory because defendants alleged the very assertion of the churning claim to be part of the conspiracy and

(footnote continued on next page)

cluded that the transaction in which the Buckley claim was assigned to plaintiff was indeed illegal and its assertion indeed tortious. But neither court held or even suggested that this barred the churning claims.

In short, once the defenses opened the door to extensive counterclaims, they were ignored as defenses.

Thus, the holding below undermined the purpose of Rule 13(a). That purpose is to promote judicial economy, prevent duplication, and avoid unnecessary burdens on the courts and the parties. *Southern Constr. Co., Inc.* v. *Pickard,* 371 U.S. 57 (1962). As the Second Circuit itself said:

> "Since a compulsory counterclaim is by definition closely related to the subject matter of the opposing party's claim, common sense and judicial economy compel the conclusion that such claims should be tried together and the extension of ancillary jurisdiction to compulsory counterclaims is consistent with Article III's grant of jurisdiction over 'cases' arising under the Constitution and federal laws." (A. 28a)

But here, rather than efficiently adjudicating related claims at the same time, the court was burdened with two totally disparate claims. The churning claims were tried (and ultimately resolved) without reference to the matters

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tortious. Lower courts have uniformly held that the assertion of wrongful conduct or improper motive for instituting the main action cannot provide the connection necessary to make a counterclaim compulsory. Solomon v. Bruckhausen, 305 F.2d 941, 943 (2d Cir. 1962), cert. denied, 371 U.S. 351 (1963); *see* 3 Moore's Federal Practice ¶13.13 at 13-308 (2d ed. 1969); 6 Wright & Miller, Federal Practice and Procedure: Civil §1411 at 56 (1969) and cases cited thereunder. Instead, they found a "logical relationship" between the churning claim and the counterclaims because "there was a substantial overlap between the defendants' defenses and their . . . counterclaims." (A. 30a)

alleged in the counterclaims. The court then proceeded to conduct what amounted to a second trial of the state counterclaims. The effect of the holding below was to complicate, not to simplify, litigation.

The Second Circuit's expansive interpretation of Rule 13(a) unduly complicates federal litigation for yet another reason. A counterclaim covered by Rule 13(a) is, of course, compulsory by definition. The Rule, as written, requires a litigant to examine the complaint and determine whether he has any claim closely connected thereto. Any such claim must be asserted, or it is thereafter barred.

Under the holding in this case, a further requirement is imposed on the litigant. He must now examine his defenses and assert all claims related to those defenses, lest they be barred. Indeed, if a counterclaim is compulsory and must be asserted, but can be asserted only by linkage to a defense, is not the defense also compulsory? The uncertainty resulting from the Second Circuit's holding will inevitably cause litigants to resolve doubts in favor of asserting all conceivable defenses and counterclaims.

B. The holding below is unique to the Second Circuit.

In creating this burdensome legacy for the federal courts, the Second Circuit went beyond existing case law. Although, as elaborated below (*infra* at 26), all courts tend to be expansive in applying Rule 13(a), the Second Circuit's holding has extended the outermost limits of this trend. The Second Circuit cited only one other decision which held a counterclaim to be compulsory because of its link to a defense: *Lesnick* v. *Public Industries Corporation*,

144 F.2d 968 (2d Cir. 1944) decided by the Second Circuit itself.

In analogous situations, this Court and the lower courts have rejected any attempt to predicate federal jurisdiction on a defense.

Thus, in *Louisville & Nashville R.R.* v. *Motley*, 211 U.S. 149 (1908), this Court expressly held that a defense was not a basis for federal question jurisdiction. In *Motley*, plaintiffs brought an action in federal court for specific performance of a contract—a state claim. The complaint alleged that defendant based its refusal to perform on an Act of Congress, but plaintiff contended the federal statute either did not justify non-performance in these circumstances or was unconstitutional. This Court noted that any justification for non-performance was a defense, not part of the claim itself. The Court concluded that federal jurisdiction can be established only on the basis of a party's statement of his own claim, not on the basis of federal questions in an anticipated defense to that claim:

> "[*A*] *suit arises under the Constitution and laws of the United States only when the plaintiff's statement of his own cause of action shows that it is based upon those laws or that Constitution.* It is not enough that the plaintiff alleges some anticipated defense to his cause of action, and asserts that the defense is invalidated by some provision of the Constitution of the United States." *Id.* at 152 (emphasis added).

The complaint was dismissed for lack of jurisdiction.

Applying that doctrine, this Court has held that, to determine whether there is federal question jurisdiction in a

declaratory judgment action, the federal courts must investigate the rules governing pleading in a hypothetical coercive action. This is to ensure that federal jurisdiction is not expanded, in violation of the intent of the Declaratory Judgment Act, where these actions present federal issues—like anticipated defenses—which would not serve as the basis of a federal claim. *Skelly Oil Co.* v. *Phillips Petroleum Co.*, 339 U.S. 667 (1950).

The Second Circuit's decision undermines this principle. Jurisdiction can be founded on "the subject matter of an opposing party's claim" only if a party's counterclaim rests not on a defense he pleads to the opposing party's complaint, but on the actual substantive legal and factual issues asserted in the opposing party's complaint.

Indeed, the Second Circuit may be poised on the brink of eliminating all remaining restraints on ancillary jurisdiction. Judge Friendly has concluded that a defendant in federal court should be permitted to assert any state counterclaim he has against the plaintiff—even if there is no independent basis for federal jurisdiction over the counterclaim and it has no relationship to the complaint. *United States* v. *Heyward Robinson Co.*, 430 F.2d 1077 (2d Cir. 1970) (Friendly, J. concurring), *cert. denied*, 400 U.S. 1021 (1971). Several commentators have also adopted this view. 3 J.W. Moore, *Federal Practice*, ¶13.19[1] at 13, 483-88 (2d ed. 1974); G.B. Fraser, *Ancillary Jurisdiction and the Joinder of Claims in the Federal Courts*, 33 F.R.D. 27 (1963); T.S. Green, Jr., *Federal Jurisdiction Over Counterclaims*, 48 N.W.U.L. Rev. 271, 278-80 (1953); J.E. Kennedy, *Counterclaims Under Rule 13*, 11 Houston L. Rev. 255, 266 (1974).

In its decision below, the Second Circuit indicated that it was interested in this concept, and the court "refrained" from exploring it only because the parties "did not ask" it to do so. (A. 27a, n.19) Inevitably, parties *will* ask the court to do so, and the Second Circuit may embrace this doctrine. Alternatively, it may achieve the same practical effect—eliminating all restrictions on ancillary jurisdiction—by enlarging the coverage of Rule 13(a) until the distinction between permissive and compulsory counterclaims becomes meaningless. It moved another step in that direction in this case.

C. There is a need for this Court to construe Rule 13(a) after 40 years of lower court experimentation.

Such expansion of Rule 13(a), spearheaded by the Second Circuit, appears inevitable in the absence of any guidance from this Court. The Federal Rules of Civil Procedure were adopted in 1938. In the ensuing 40 years, this Court has never construed the "transaction or occurrence" language of Rule 13(a). It has never issued guidelines, discussed relevant criteria, or probed the outer limits of the compulsory counterclaim doctrine.

Only twice has the Court even addressed Rule 13(a). On each occasion, it held that the counterclaim under consideration was not compulsory—on grounds not here relevant. See *Southern Construction Company, Inc.* v. *Pickard*, 371 U.S. 57 (1962); and *Mercoid Corp.* v. *Mid-Continental Co.*, 320 U.S. 661 (1944). Nothing in either holding suggests the expansive reading adopted below. But neither of these cases—or any other Supreme Court case—promulgates standards for the application of Rule 13(a).

In the absence of any Supreme Court interpretation of Rule 13(a), the lower courts have reached back to its predecessor—Equity Rule 30—adopted in 1912. They have sought guidance from this Court's discussion of Equity Rule 30 in *Moore* v. *New York Cotton Exchange*, 270 U.S. 593 (1926). In its decision below, the Second Circuit ritualistically invoked the following language used by this Court fifty years ago in *Moore*:

> " 'Transaction' [as used in Equity Rule 30] is a word of flexible meaning. It may comprehend a series of many occurrences, depending not so much upon the immediateness of their connection as upon their logical relationship." (A. 28a, n.20)

Fifty years is a long time. Federal litigation is far more complex, federal and state claims far more diverse, and federal courts far more heavily burdened than a half-century ago. Surely, after fifty years, it is time to take another look at the very general language of *Moore* and the very expansive rulings which have been promulgated in its name.

One thing is very clear: Lacking specific guidance from this Court, and invoking the general language of *Moore* for legitimacy, the lower courts have read Rule 13(a) very expansively indeed. We have noted above that the Second Circuit is a trail blazer in this effort. But we readily acknowledge that other Circuits have utilized Rule 13(a) to extend their subject matter jurisdiction. As the District Court below stated, there is a "general trend toward expansion of the concept of compulsory counterclaims." (C. 83a)

As a result, the federal courts are increasingly open to litigants asserting non-diverse state claims, and federal actions are increasingly expanded by counterclaims that belong in the state courts. Review of the decision below will give this Court an opportunity to restore some vitality to Rule 13(a) and provide guidance for its application. After 50 years, we respectfully submit, such guidance is urgently needed.

D. The decision below will impose new burdens on the federal courts and increasingly involve them in areas reserved to the states.

Absent such guidance, the decision below has significant —and unfortunate—implications for the federal courts.

Its holding that even marginally related counterclaims are compulsory brings into the sweep of federal ancillary jurisdiction state claims which have little or no bearing on any case properly in federal court and which otherwise could not be heard there. In view of the large number of cases in which litigants have opposing claims against another party, the volume of state claims the federal courts would have to adjudicate under this ruling would be substantial.

The extension of ancillary jurisdiction under such a broad reading of the Rule conflicts with the Rules Enabling Act, 28 U.S.C. §2072 (1970), and Fed. R. Civ. Proc. 82, which prohibit the Federal Rules from expanding the scope of federal jurisdiction. More importantly, the decision contravenes federal constitutional and statutory policies carefully limiting federal jurisdiction.

The federal courts do not, of course, have general jurisdiction over state or even federal claims; their power is limited by the Constitution and by statute. This Court has long recognized that the scope of federal jurisdiction must be construed in light of the Constitutional and statutory policies underlying these limitations. *Indianapolis* v. *Chase National Bank,* 314 U.S. 63, 76 (1941) (Frankfurter, J); *see also Skelly Oil Co.* v. *Phillips Petroleum Co.,* 339 U.S. 667 (1950). For example, this Court has strictly construed the minimum amount in controversy requirement in light of Congressional intent to diminish the federal caseload. *Zahn* v. *International Paper Co.,* 414 U.S. 291 (1973).

In particular, this Court has a long standing policy limiting unnecessary determination of state law issues in the federal courts when they are not bound up with federal issues and can be referred to the state courts. Thus, its policy is to construe the diversity statute strictly in light of the Congressional intent to "jealously restrict" federal jurisdiction over state claims to "relieve the federal courts of the overwhelming burden of business that intrinsically belongs in the state courts in order to keep them free for their distinctive business," and to foster Constitutional policies "of avoiding offense to state sensitiveness." *Indianapolis* v. *Chase National Bank,* 314 U.S. at 76. Moreover, this Court has evolved an elaborate doctrine of abstention to avoid interfering with the states' autonomy by unnecessary federal consideration of novel state law issues. *See, e.g., Rizzo* v. *Goode,* 425 U.S. 993 (1976).

Review of the decision below is needed to reconcile the concept of ancillary jurisdiction with these fundamental

Constitutional and statutory policies. The expansion of ancillary jurisdiction envisioned by the Second Circuit would disturb the balance between federal and state courts. It would divert from the state to the federal courts a large body of state cases on a compulsory basis. It would require the federal courts to confront unsettled questions of state law, and impede the state courts in exercising their proper function in our federal system.

Adjudication of these cases would thrust an undesirable and especially laborious burden on the already overburdened federal courts, which cannot speak with their own authority on these issues. In 1969, the Study of the Division of Jurisdiction Between State and Federal Courts concluded that it was "intolerable" that the constant and growing pressures of state law cases paralyzed the federal courts from exercising their proper role of adjudicating federal claims. American Law Institute, *Study of the Division of Jurisdiction Between State and Federal Courts* (1969) at 1. It concluded that the proper place for most state claims is in the state courts.

This conclusion speaks with a special urgency today in view of the continually expanding workload of the federal courts and the pressures of the Speedy Trial Act. At an ever-growing pace, the federal caseload has risen dramatically because of the increased complexity of society and the expansion of federal law. From 1960 to 1975, the federal caseload grew by more than 106 percent, and it continues to rise. R.H. Bork, *Dealing with the Overload in Article III Courts*, 70 F.R.D. 231 (1976). This case presents the Court with an opportunity to restrain that trend.

II

Review is needed to apply, in the area of ancillary jurisdiction over counterclaims, the cautionary policy articulated in this Court's opinion in *Aldinger* v. *Howard*.

In *Moor* v. *County of Alameda*, 411 U.S. 693, 715 (1973), *Philbrook* v. *Glodgett*, 421 U.S. 707 (1975) and *Aldinger* v. *Howard*, 427 U.S. 1 (1976), this Court confronted what it termed a "subtle and complex question with far reaching implications": whether pendent jurisdiction can be asserted over a third party as to whom there is no independent basis of federal jurisdiction. This case sharply presents the same recurring issue in the context of ancillary jurisdiction. Petitioners submit that the courts below erred in exercising jurisdiction over 19 counterclaim defendants who were total strangers to this litigation and for whom there was no independent basis of federal jurisdiction.

Ancillary jurisdiction, like pendent jurisdiction, is a court-fashioned doctrine founded on the principles of judicial convenience, economy and efficiency. *Cf. United Mine Workers* v. *Gibbs*, 383 U.S. 715 (1966) with *Moore* v. *New York Cotton Exchange*, 270 U.S. 593 (1926). Like pendent jurisdiction, ancillary jurisdiction enables the federal courts to avoid piecemeal litigation and to afford complete relief to the parties. The same considerations of the Constitutional and practical limitations on the federal courts should be applicable to both doctrines, and they should be treated the same for the purposes of determining jurisdiction. W.D. Claster, *Pendent and Ancillary Jurisdic-*

tion: *Twards A Synthesis of Two Doctrines,* 22 U.C.L.A. L. Rev. 1263 (1975).

In *Moor,* this Court faced the question of whether, in a federal civil rights suit brought against a county's police officers, a federal court could exercise pendent jurisdiction over a state claim against the county, which was a stranger to the federal claim. The Court concluded that it was not necessary to decide the issue on jurisdictional grounds. It pointed out that pendent jurisdiction rests not only on the power but also on the discretion of the federal courts. This Court affirmed the lower courts' discretionary refusal to hear the claim; it did not reach the question of whether the lower courts actually had power to hear the claim.

Similarly, *Philbrook,* 421 U.S. 707 (1975), presented the question of whether pendent jurisdiction could be applied to third parties, but the Court did not find it necessary to resolve the question because the issue was not briefed and was of no practical significance to the parties.

In *Aldinger* v. *Howard,* 427 U.S. 1 (1976), this Court was presented with the same issue raised by *Moor.* This time, however, the Court concluded that the lower courts did not have pendent jurisdiction over the third party. Although the Court's holding was narrow,* it clearly expressed grave doubts about ever exercising pending jurisdiction over third parties for whom there was no independent basis of federal jurisdiction. The Court concluded:

> "From a purely factual point of view, it is one thing to authorize two parties, already present in federal

*The Court relied on the fact that the Civil Rights Act did not cover county governments. Under those circumstances, it held, Congress could not have intended the federal courts to exercise pendent jurisdiction, based on the same allegations, over state claims asserted against the same county governments.

> court by virtue of a case over which the court has jurisdiction, to litigate in addition to their federal claim a state law claim over which there is no independent basis of federal jurisdiction. But it is quite another thing to permit a plaintiff who has asserted a claim against one defendant with respect to which there is federal jurisdiction, to implead an entirely different defendant on the basis of a state law claim over which there is no independent basis of federal jurisdiction, simply because his claims against the first defendant and his claim against the second defendant 'derive from a common nucleus of operative fact.' " 427 U.S. at 14.

Several lower federal courts, like the courts below, have held that a district court's ancillary jurisdiction extends to additional third parties whose presence is required for adjudication of a compulsory counterclaim. *See e.g., H.L. Peterson Co.* v. *Applewhite,* 383 F.2d 430 (5th Cir. 1967); *Albright* v. *Gates,* 362 F.2d 928 (9th Cir. 1966); *United Artists Corp.* v. *Masterpiece Productions, Inc.,* 221 F.2d 213 (2d Cir. 1955). In *Moor,* this Court noted the existence of these authorities, 411 U.S. at 714-15. It did not deal with them because *Moor* did not involve ancillary jurisdiction. The Second Circuit, in its opinion below, apparently construed the Court's silence as acquiescence. (A. 27a)

We respectfully submit that *Moor* does not stand for this proposition, that this proposition cannot withstand constitutional scrutiny, and that it cannot be squared with this Court's reservations in *Aldinger.* The Federal Rules permit impleading of a third party to a compulsory counterclaim, Fed. R. Civ. Proc. 13(h). However, under *Aldinger's* recognition of the constitutional limitations on federal ju-

risdiction, the federal courts must have an independent basis of jurisdiction to hear the claim asserted against the third party.

This case presents the *Aldinger* issues in a more important context. Whereas pendent jurisdiction claims are asserted only occasionally, the potential for asserting state counterclaims against non-diverse third parties exists in many cases. The potential for abuse is compounded where, as here, the counterclaims asserted have only the most attenuated link to the complaint. We urge the Court to take this opportunity to apply the principle of *Aldinger* to ancillary jurisdiction cases.

Conclusion

We submit that these issues are of importance and worthy of this Court's attention. The petition for a writ of certiorari should be granted.

Respectfully submitted,

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Dated: November 21, 1977

APPENDIX A

Opinion of the United States Court of Appeals for the Second Circuit

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 897-904—September Term, 1976.

(Argued May 11, 1977 Decided August 24, 1977.)

Docket Nos. 76-7476, 76-7486, 76-7488, 76-7489, 76-7494, 76-7495, 76-7499, 76-7500

NEWBURGER, LOEB & CO., INC., as Assignee of Claims of David Buckley and Mary Buckley,

Plaintiff-Appellant-Cross-Appellee,

v.

CHARLES GROSS, MABEL BLEICH, GROSS & CO., and JEANNE DONOGHUE,

Defendants-Appellees-Cross-Appellants,

NEWBURGER, LOEB & CO., a New York Limited Partnership, ANDREW M. NEWBURGER, ROBERT L. NEWBURGER, RICHARD D. STERN, WALTER D. STERN, and ROBERT L. STERN as Executors of the Estate of Leo Stern, ROBERT L. STERN, RICHARD D. STERN, JOHN F. SETTEL, HAROLD J. RICHARDS, SANFORD ROGGENBURG, HARRY B. FRANK and JEROME TARNOFF as Executors of the Estate of Ned D. Frank, FRED KAYNE, ROBERT MUH, PAUL RISHER, CHARLES SLOANE, ROBERT S. PERSKY, FINLEY, KUMBLE, WAGNER, HEINE, UNDERBERG & GRUTMAN, a Partnership (formerly known as Finley, Kumble, Underberg, Persky & Roth and Finley, Kumble, Heine, Underberg & Grutman) and LAWRENCE J. BERKOWITZ,

Additional Defendants on Counterclaims-Appellants-Cross-Appellees.

Appendix A

Before:

LUMBARD and MESKILL, *Circuit Judges*,
and JAMESON, *District Judge.**

Cross appeals from a judgment of the Southern District, Owen, *Judge*, which dismissed plaintiff's churning claim under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b), awarded judgment on certain of defendants' counterclaims for civil conspiracy, violation of state partnership law, breach of fiduciary obligation, and conversion, and which dismissed the remaining state and federal counterclaims of the plaintiff, defendants, and additional defendants on the counterclaims.

Affirmed in part; reversed and remanded in part.

DONALD H. SHAW, New York, N.Y. (Kantor, Shaw & Davidoff, P.C., New York, N.Y., on the brief), *for Plaintiff-Appellant-Cross-Appellee, Newburger, Loeb & Co., Inc.*

PHILIP MANDEL, New York, N.Y. (Golden, Wienshienk & Mandel, Ralph Wienshienk, Bernard Rothman, Marc Owen Mandel and Arthur Tarlow, New York, N.Y., on the brief), *for Defendants-Appellees-Cross-Appellants.*

SIMON H. RIFKIND, New York, N.Y. (Paul, Weiss, Rifkind, Wharton & Garrison, New York, N.Y.; Finley, Kumble, Wagner, Heine & Underberg, New York, N.Y.; Mark H. Alcott, John M. Delehanty, Beryl A. Schatz, and Alan M. Gelb, on the brief), *for Additional Defendant on Counterclaims-Appellant-Cross-Appellee Finley, Kumble, Wagner, Heine, Underberg & Grutman.*

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* Sitting by designation.

Appendix A

PAUL D. RISHER, New York, N.Y., *for Additional Defendant on Counterclaims-Appellant-Cross-Appellee Pro Se.*

LEON B. BORSTEIN, New York, N.Y. (Shaw and Stedina, New York, N.Y., on the brief), *for Additional Defendant on Counterclaims-Appellant-Cross-Appellee Robert Muh.*

MARTIN E. SILFEN, GOLD, FARRELL & MARKS, THOMAS R. FARRELL and LEONARD M. MARKS, New York, N.Y., on the brief, *for Additional Defendant on Counterclaims-Appellant-Cross-Appellee Fred Kayne.*

OSMOND K. FRAENKEL, New York, N.Y., *for Additional Defendants on Counterclaims-Appellants-Cross-Appellees Newburger, Loeb & Co., Andrew M. Newburger, Robert L. Newburger, Robert L. Stern, Richard D. Stern, Walter D. Stern and Robert L. Stern, as Executors Under the Last Will and Testament of Leo Stern, Deceased; and Sanford Roggenburg.*

LAWRENCE J. BERKOWITZ, New York, N.Y., on the brief, *for Additional Defendant on Counterclaims-Cross-Appellee Pro Se.*

ELAINE PLATT and LEON B. BORSTEIN, New York, N.Y., on the brief, *for Additional Defendant on Counterclaims-Appellant-Cross-Appellee Charles Sloane.*

ROBERT S. PERSKY, New York, N.Y., on the brief, *for Additional Defendant on Counterclaims-Appellant-Cross-Appellee Pro Se.*

Appendix A

LUMBARD, *Circuit Judge*:

These appeals and cross appeals from a judgment of the Southern District, Owen, *Judge,* are the latest chapter in the financial misfortunes of New York brokerage firm of Newburger, Loeb & Co. (hereinafter the "Partnership") and its successor, Newburger, Loeb & Co., Inc. (hereinafter the "Corporation") during the years 1969-71, which resulted in the departure of the managing partner, Charles Gross, and the arrangements made by the survivors and others to reorganize and rescue the business.

We affirm so much of the judgment of the district court which:

(1) Dismissed, as lacking in merit, the Corporation's churning claim, under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b), against defendants Charles Gross, Mabel Bleich, Jeanne Donoghue, and Gross & Co.

(2) Awarded judgment to the defendants on their first, second and fourth counterclaims against the Corporation, and against the Partnership, individual members of the Partnership,[1] the promoters of the Corporation,[2] and Rob-

1. Andrew M. Newburger, Robert L. Newburger, Leo Stern, Robert L. Stern, Richard D. Stern, Harold J. Richards, Sanford Roggenburg, John F. Settel, and Ned D. Frank.

2. Fred Kayne, Paul Risher, Robert Muh, Charles Sloane and Lawrence Berkowitz were alleged by the defendants and found by the court to be the promoters. The court dismissed defendants' first, second and fourth counterclaims against Berkowitz on the ground that there was not sufficient proof of his participation in the conspiracy. As the defendants have failed to provide any substantial argument why the district court's findings of fact regarding Berkowitz are erroneous, we affirm the dismissal of these claims against Berkowitz.

The case against Alex Aixala was dismissed at the close of defendants' proof and defendants have not argued that this was error.

ert S. Persky and his law firm, Finley, Kumble, Underberg, Persky & Roth (which at the time of judgment was known as Finley, Kumble, Wagner, Heine, Underberg & Grutman), who were brought in as additional defendants on the counterclaims, for conspiracy to injure the defendants with respect to their interests in the Partnership.

We hold that the district court properly exercised its ancillary jurisdiction over these counterclaims.

(3) Dismissed, as lacking in merit, defendants' ninth counterclaim under the federal antitrust laws for destruction of Gross' employment opportunity with Rafkind & Co., a New York brokerage firm.

(4) Dismissed defendants' fifth, sixth, seventh and eighth counterclaims for lack of subject matter jurisdiction.

(5) Dismissed the six counterclaims of the Corporation and the additional defendants against Gross.

We reverse those parts of the judgment which:

(1) Awarded judgment to Gross on defendants' third counterclaim for conversion of Gross' interest in warrants to buy stock of Geon Industries, Inc., and Computer Softwear Systems, Inc.

We hold that Judge Owen erroneously exercised jurisdiction over this claim after Judge Ward correctly held that it was not within the ancillary jurisdiction of the court.

(2) Awarded $50,000 punitive damages to Gross.

Finally, although we affirm the finding of liability on defendants' first, second and fourth counterclaims, we remand these counterclaims for recomputation of damages in

light of our reversal of defendants' third counterclaim and certain difficulties with the court's computation of damages.

To further discussion of the issues, we summarize the underlying facts. The partnership was an established Wall Street brokerage firm. From about May 1959 through December 31, 1968 it acted as a clearing house for the partnership of Gross & Co., which consisted in part of Charles Gross, his sister, Jeanne Donoghue, his secretary, Mabel Bleich, and Charles Jordon; thus, the Partnership executed orders for Gross & Co. and sent confirmations and statements to its customers. Among these customers were David and Mary Buckley, who had an active account with Gross & Co. in 1962-66.

In 1969 Gross & Co. liquidated and on January 1, 1969, Gross became a general partner in the Partnership with an initial investment of about $400,000. Bleich and Donoghue became limited partners, investing about $75,000 each. Gross soon thereafter became managing partner of the Partnership and invested another $400,000 in the firm. The Partnership began to experience the record-keeping problems common on Wall Street in late 1969 and early 1970 caused by the greatly increased volume of transactions in the 1960's, which have come to be known as the "back office crunch," see, e.g., *Hirsch* v. *du Pont,* No. 76-7428, slip op. 2747 (2d Cir. April 7, 1977). By the summer of 1970 the firm was experiencing serious capital problems. A number of the partners expressed dissatisfaction with Gross' management, and he stepped down as managing partner. As he was not satisfied with the proposed new management, Gross gave notice of his withdrawal from the firm on

August 31, 1970, which under the terms of the partnership agreement became effective as of September 30, 1970. Gross also demanded the return of his "additional capital" (claimed to be $400,000) and fifteen per cent of his "committed capital," pursuant to the partnership agreement. The agreement provided that at least eighty-five per cent of the "partnership interest" of a withdrawn general partner remained in the firm, at the risk of the business, for twelve months from the effective date of withdrawal. On December 31, 1970, Bleich and Donoghue submitted notices of withdrawal from the firm.

Fred Kayne became managing partner after Gross stepped down. Before joining the Partnership Kayne and Charles Sloane had been employed as registered representatives of the firm at its California office. According to Kayne and Sloane, they were induced by Gross to join the firm and became general partners in late February, 1970, each investing $50,000. In the summer of 1970, after becoming managing partner, Kayne brought in Robert Muh and Paul Risher as consultants. At about this time, the law firm of Finley, Kumble, Underberg, Persky & Roth began to handle legal matters for the Partnership, with Robert S. Persky as the partner in charge.

Defendants allege that shortly after Kayne became managing partner he began to plot with Muh, Risher, Sloane, Lawrence J. Berkowitz (house counsel to the Partnership), and Persky to transform the Partnership into a corporation and to gain control of its assets for a small investment. According to the testimony of Gross, early in September, 1970, he met with Persky and Kayne who attempted to

persuade him not to withdraw from the Partnership and who told him that he would "be sorry" if he did not cooperate.

The fortunes of the Partnership continued to dwindle, however, and in November, 1970, both Kayne and Sloane withdrew. On November 17, 1970, the New York Stock Exchange notified the firm that if it was not in compliance with the "required excess capital" provision of the Exchange constitution by November 20, steps would be taken to suspend the firm. The Partnership was also directed to prepare for possible liquidation.

Under continuing pressure from the Exchange, a reorganization was proposed by Risher and Muh as an alternative to the Partnership liquidation. The assets of the Partnership were to be transferred to a corporation; in return, the general and limited partners and the subordinated lenders were to receive a variety of securities in accordance with their capital positions. The corporation's promoters were Berkowitz, Kayne, Muh, Risher and Sloane. See note 2, supra. In return for investments of $10,000 each, Kayne, Risher, and Muh would each receive sixteen per cent of the common stock. Kayne and Sloane were to participate in management along with Risher and Muh. An infusion of fresh capital was to come from Alex Aixala (in the form of $1,000,000 worth of Bacardi stock), an investor brought in by Persky.

After numerous negotiations, Gross, Bleich and Donoghue refused to consent to the proposed transfer of assets; apparently, Gross felt the proposed transfer was a plot by the promoters to gain control of the Partnership assets

for a small investment. The Corporation and the additional defendants contend, on the other hand, that Gross had no legal right to object to the reorganization and was merely attempting to gain a special benefit for himself by demanding a cash return of part of his investment. Although it appears that the promoters did not believe that Gross' consent (as a withdrawn general partner) was necessary to the reorganization, Gross contends they wished to dissuade him from withdrawing his capital. In any event, Bleich and Donoghue would not consent to the transfer without Gross' approval, and the promoters believed that the transfer could not be legally completed under New York law without the consent of Bleich and Donoghue (who were withdrawn limited partners).

According to the defendants, numerous attempts were made to "persuade" the defendants (particularly Gross) to consent to the transfer. The principal coercive tactic was the threat to tie up the defendants in lengthy litigation, including (1) the threat to bring suit on a claim of churning the account of David and Mary Buckley, and (2) the threat to sue Gross for fraudulently inducing Kayne and Sloane to join the Partnership and for mismanaging the Partnership's assets.

David and Mary Buckley maintained an account with Gross & Co. from April, 1962 through August, 1966, which was handled by Charles Jordon. Although the account was extremely active, by August, 1966, it showed a deficit of $332,000, which was owed to the Partnership as the clearing house. Between 1966 and 1970 unsuccessful efforts were made to collect the amounts owing. The Buckleys

threatened bankruptcy if the collection efforts were pressed. In 1970 the Partnership commenced an arbitration proceeding under the rules of the Exchange. The Buckleys asserted one set-off and two counterclaims against the Partnership. The first counterclaim alleged that their account had been churned by Gross & Co. during the years 1962-66, for which the Buckleys claimed $75,000 in damages. Richard Miles, director of compliance for the Partnership in 1969-70, testified that the Buckley account was referred to him in 1970 by Leo Stern, a general partner. Miles concluded that the churning claim was without merit and was asserted as a bargaining tool. Miles testified that he communicated this evaluation to Robert Stern, the general partner to whom Miles reported, who agreed with this evaluation. According to Persky's testimony, the collection file was turned over to him in November or December of 1970. On December 30, 1970, the Partnership's $332,000 claim against the Buckleys was settled; the Buckleys agreed to pay the Partnership $50,000 and assign to it the churning claim against Gross & Co. in exchange for a release.

Risher testified that after the settlement Persky called him and stated that he thought it was a "good idea" to get the assignment of the churning claim. Persky stated in his deposition that the idea of obtaining the Buckley claim originated with him, that before and after the settlement there were discussions as to how the claim might be used in negotiations with Gross, and that he believed the churning claim might bring home to Gross "the reality of the situation." Despite the fact that there is no evidence that

the Buckleys ever dealt with Charles Gross personally, the complaint in this case, which was prepared by Persky, alleged that Gross was the customer's man with whom the Buckleys dealt;[3] further, as the district court found, when this error was pointed out to Finley, Kimble, no attempt was made to correct it or to add Charles Jordon as a party. The amount of damages claimed by the Corporation was $250,000—more than three times the amount claimed by the Buckleys.

Gross testified that at a meeting on January 15, 1971, attended by Risher, Muh, and Persky, he was told by Persky that he should go along with the proposed transfer and convince Bleich and Donoghue to consent. Persky told Gross that there were many claims that could be used against him if they "stood in the way of the deal," including the Buckley claim and allegations of malfeasance and it was in Gross' interest "not to be tied up in litigation for a long, long time, and to be free to work in the street." Persky told Gross to take the Buckley claim "very, very seriously." Gross refused to bend. He told Persky, Risher and Muh that they could keep their claims and that he thought the fairest solution was for the Partnership to

3. At a general meeting of the limited partners, general partners and subordinated lenders, held early in February, 1971, prior to the transfer, Persky circulated a complaint prepared for the Partnership similar to the Corporation's complaint in this case. It contained the same factual errors concerning Gross' dealings with the Buckleys. Defendants allege that the complaint was circulated to convince the limited partners and subordinated lenders that there were valid claims outstanding against Gross, Bleich and Donoghue, which could be used to prevent them from withdrawing their capital. Persky admitted at trial that the limited partners and subordinated lenders would not have allowed the transfer to take place if Gross, Bleich and Donoghue's demands for immediate payment of their capital contributions had been met.

liquidate. Shortly after this meeting concluded, Gross received a call from Kayne and Sloane in California. Sloane was extremely angry and told Gross that they had heard what had happened at the meeting and that, "If you kill this deal, we are going to sue you. You will be sued for a long time. You may never get out of the courts."

Similarly, on January 23, 1971, Kayne called Gross and arranged to meet him for lunch. Gross testified that at this meeting Kayne threatened him with litigation in California if he did not consent to the transfer. The district court credited Gross' version of these meetings. In addition to finding that various threats had been made against Gross, the court found, based on the testimony of Bleich, that Risher threatened Bleich with the Buckley claim to a point that made her cry.

On February 3, 1971, eight days prior to the date set for the proposed transfer of assets, Kayne and Sloane sued Gross in the District Court for the Central District of California, charging that Gross had fraudulently induced them to join the Partnership and had mismanaged its assets. Eventually, this suit was dismissed after a NYSE arbitration, which found in favor of Gross. The present suit was commenced by the Corporation on February 17, 1971.

Gross also claimed that an additional tactic used to coerce his consent was the destruction of a job opportunity. The Partnership articles, which were effective for a period of two years, provided that any general partner who voluntarily withdrew from the Partnership (as did Gross) could not "engage in the business of broker or dealer in securi-

ties and commodities whether for his own account or for others'' until the expiration of the partnership agreement on December 31, 1971. After Gross left the Partnership, he was offered a job opportunity as a trader by Rafkind & Co. On January 19, 1971, Rafkind wrote the Partnership requesting clearance to employ Gross. Gross alleges that Berkowitz threatened Rafkind with suit, and in any case, Berkowitz sent a letter to Rafkind informing it of the Partnership covenant not to compete; the letter also indicated that the Exchange had been notified that Gross was subject to the restrictive covenant. Rafkind then dropped the job offer and so informed the Partnership. Gross claims that at a meeting on February 5, 1971, he was told by Risher that if an ''accommodation'' could be reached, he could have his job with Rafkind. However, despite these and other coercive tactics alleged by the defendants, Gross, Bleich and Donoghue refused to consent to the transfer.

The closing date for the transfer of assets from the Partnership to the Corporation had been set for February 11, 1971. The Exchange had advised the Partnership that if the required improvements in its capital position were not made, the Partnership would be suspended on February 12, 1971. The record indicates that at the January 15, 1971, meeting, attended by Persky, Risher and Muh, counsel for the defendants Philip Mandel, stated that the transfer could not legally take place without the consent of Gross, Bleich and Donoghue.

A condition precedent to the Corporation's obligation to execute the transfer agreement was the issuance of a letter of opinion from counsel to the Partnership, stating

that the Partnership had the authority to make the transfer. Paul Burak, whose firm, Rosenman, Colin, Kaye, Petschek, Freund & Emil, had been retained to represent the Partnership, testified that a member of his firm researched the issue and concluded in a memorandum dated January 25, 1971, that under New York Partnership Law §98, the transfer could not take place without the consent of all of the limited partners. Section 98(1)(b) provides, *inter alia*, that without the consent of all limited partners, a general partner or all of the general partners have no authority to "[d]o any act which would make it impossible to carry on the ordinary business of the partnership." Burak conveyed his firm's position, that the transfer could not be conducted without the consent of all of the limited partners, to the Partnership; specifically, he testified that he discussed the matter with Andrew Newburger. Burak also conferred with Persky, who unsuccessfully attempted to persuade Rosenman, Colin to give a favorable opinion.

On the day of the closing, Rosenman, Colin refused to issue the letter of opinion. However, Persky, whose firm now represented the Corporation, stated that his firm had done some research in the area and it was agreed that Persky would issue the opinion letter as special counsel to the Partnership. The letter was issued, examined by counsel for the parties, and the deal was closed.

Under the transfer agreement the Corporation agreed to assume all liability for the claims of Gross, Bleich and Donoghue arising out of the transfer. The Corporation set up a reserve fund of $300,000 for this purpose.[4] How-

4. While the Corporation stayed solvent for over two years after the transfer, it appears the reorganization merely delayed the inevitable. In November, 1973, the Corporation filed a petition in bankruptcy under Chapter XI, where, the litigants have informed us, it remains to date.

ever, no payments were or have been made to Gross, Bleich or Donoghue.

On February 17, 1971, the Corporation commenced this action as an assignee of the Buckley claim. The complaint stated that the Buckleys had assigned their claims to the Partnership and that the Partnership had assigned these claims to the Corporation on February 11, 1971. Although the complaint states five "causes of action," essentially it alleges that Gross, Bleich and Gross & Co. were liable for the churning of the Buckleys' account under the federal securities law and state common law and that plaintiff was entitled to attorney's fees. In their amended answer, which was joined in by Donoghue,[5] defendants raised nine counterclaims against the Corporation, the members of the Partnership who participated in the transfer, the promoters of the Corporation, Robert S. Persky and his former law firm, Finley, Kumble.[6]

The defendants' nine counterclaims allege, in relevant part, the following:

First counterclaim (and second defense): the transfer agreement (which includes the assignment of the Buckley claim to the Corporation) is ineffective because it was executed in violation of section 98 of New York Partnership

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5. Although Donoghue was not named as a defendant in the original complaint, she was later officially granted leave to intervene by Judge Owen, apparently both as a defendant to the Buckley claim and as a plaintiff on the counterclaims. See *Newburger, Loeb & Co., Inc.* v. *Gross*, 62 F.R.D. 397 (S.D.N.Y. 1974).

6. Finley, Kumble and Persky were not named as additional defendants in the defendants' original answer, filed on May 3, 1971. They were brought in by the amended answer, filed on February 28, 1972. Defendants explain that it was not until extensive discovery was had that they discerned Persky's role in the conspiracy.

Law; defendants demand the transfer be set aside and the counterclaim defendants be held liable for damages.

Second counterclaim (and fifth defense): the settlement of the Buckley claim and its subsequent assignment to the Corporation was undertaken in bad faith in violation of the Partnership's fiduciary obligations to the defendants as a means of resisting payment of the defendants' capital interests in the Partnership; further, defendants allege that the transfer of the Partnership assets was itself a breach of fiduciary obligation. Defendants demand an accounting and the imposition of a constructive trust.

Third counterclaim: the counterclaim defendants converted certain stock warrants, which were the property of Gross, when these warrants were transferred to the Corporation as part of the Partnership's assets.

Fourth counterclaim: all of the counterclaim defendants engaged in a conspiracy to force the defendants to consent to the transfer agreement, which included manipulating the assignment of the Buckley claim and threatening the defendants with litigation.

Fifth and sixth counterclaims: pursuant to the Partnership agreement, Bleich and Donoghue are entitled to the return of their capital investments.

Seventh counterclaim: pursuant to the Partnership agreement, Gross is entitled to an accounting to determine his capital interest.

Eighth counterclaim: the counterclaim defendants "maliciously" blocked Gross' employment with Rafkind & Co. by informing it that his employment would violate the Partnership agreement.

Appendix A

Ninth counterclaim: the destruction of the Rafkind opportunity violates the federal antitrust laws; Gross demands treble damages.[7]

Prior to trial, the Corporation and the additional defendants moved to dismiss defendants' state law counterclaims for lack of subject matter jurisdiction. The parties also made cross motions for summary judgment.

Judge Ward in his opinion of October 16, 1973, first held that the defendants' first and second state law counterclaims were so closely linked to defenses to plaintiff's churning claims "that they must be considered 'logically related to the claim the opposing party is suing on,'" quoting C. Wright, *Law of Federal Courts* 346 (2d ed. 1970), and, thus, were compulsory counterclaims within the court's ancillary jurisdiction. The court found that the fourth counterclaim asserted the same allegedly wrongful acts and should also be treated as a compulsory counterclaim. *Newburger, Loeb & Co., Inc.* v. *Gross*, 365 F. Supp. 1364, 1367 (S.D.N.Y. 1973).[8] However, the court found that defendants' third, fifth, sixth, seventh and eighth counterclaims were not "logically related" to the Corporation's claims and thus were not compulsory counterclaims; there being no independent jurisdictional basis for these state law claims, the court held they could be maintained

7. Although the ninth counterclaim refers to numerous allegations as the basis for charging violation of the antitrust laws, the defendants' brief on appeal confines itself to the argument that the circumstances surrounding the alleged destruction of the Rafkind opportunity violated the antitrust laws.

8. It appears that neither the Corporation nor any of the additional defendants made an attempt to pursue an interlocutory appeal from Judge Ward's finding of jurisdiction over these counterclaims by seeking certification pursuant to 28 U.S.C. §1292(b).

only as a set-off to defeat or reduce any recovery on the Corporation's claims.[9] See *United States* v. *Heyward-Robinson Company*, 430 F.2d 1077, 1081, n.1 (2d Cir. 1970), cert. denied, 400 U.S. 1021 (1971).

Turning to defendants' motion for summary judgment, Judge Ward found that the transfer of the Partnership assets to the Corporation without the consent of Bleich and Donoghue violated section 98(1)(b) of New York Partnership Law.[10] However, since the only interest of Gross, Bleich and Donoghue in the Partnership was the right to be paid a certain sum of money, the court found that damages were an adequate remedy and, thus, that rescission would be inappropriate. 365 F. Supp. at 1370. Determination of the amount of damages was left for trial.

Judge Ward also concluded that the Corporation's churning claim presented triable issues and that under New York law, the Partnership was not prohibited from taking the assignment of the Buckley claim "if such an assignment is taken in good faith and does not breach the fiduciary duty owed to the partners being sued. The issue is that of the good faith of the Partnership and of Persky,

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9. Defendants' ninth counterclaim, of course, rested upon an independent jurisdictional basis. Though Judge Ward found the claim "skeletal," it was held sufficient to withstand a motion to dismiss for failure to state a claim. 365 F. Supp. at 1367-68.

10. As noted, supra, §98(1)(b) provides that general partners may not, without the consent of all of the limited partners, "[d]o any act which would make it impossible to carry on the ordinary business of the partnership." Although Bleich and Donoghue had withdrawn from the Partnership on December 31, 1971, prior to the transfer, as the district court noted, under the Partnership articles they retained their status as limited partners for six months thereafter. Accordingly, the district court found that under §98, their consent to the February 11, 1971, transfer was required.

the attorney representing it." 365 F. Supp. at 1370. Since the issue of good faith presented a question of fact, Judge Ward denied summary judgment on this issue.

On January 16, 1974, the Corporation and the additional defendants added six counterclaims against Gross, which alleged that he had committed various acts of mismanagement as managing partner.

Trial commenced before Judge Owen on June 16, 1975, and concluded on August 1, 1975. In his July 7, 1976 opinion, Judge Owen dismissed the Corporation's first, second, fourth and fifth claims, based on the alleged churning of the Buckley account.[11] Although he noted that there were a large number of transactions in the account, he found that they were motivated by David Buckley's desire to make a fortune in the market by speculation. The court found that Buckley was an experienced investor, that the account was non-discretionary and that Buckley had to and did authorize every transaction, and concluded that there was "no question that the churning claim has not been proved."

Turning next to defendants' counterclaims, the court held that the promoters (except Berkowitz) as officers of the Corporation, guided by Persky, and the members of the Partnership had engaged in a conspiracy "to injure Gross, Bleich and Donoghue in their interests in the Partnership." Specifically, the court found that the injury to the defend-

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11. The Corporation's third cause of action, which alleged that the churning of the Buckley account violated section 15(c)(1) of the Securities Exchange Act of 1934, 15 U.S.C. §78o(c)(1), and Rule 15C-1(7) promulgated thereunder, had previously been dismissed by Judge Ward as time-barred. 365 F. Supp. at 1371-72. The Corporation has not appealed the dismissal of this claim.

ants was part of a plot instituted by Kayne, Risher, Sloane, Muh, and Persky, "to take over the new operation on a shoestring and directly enrich themselves."

Judge Owen found that "in major measure" the consent of the general partners was obtained by arranging a "forgiveness" of some $500,000 of capital arrears owed to the Partnership by various partners. Gross, who owed no captial arrears and had invested some $800,000 in the firm, specifically objected to the forgiveness in refusing to go along with the transfer.

The court found that another "problem" faced by the promoters was to minimize any outflow of cash to Gross, Donoghue and Bleich. It was determined that the way to deal with Gross was to threaten him with prospective or actual litigation, which would either coerce his consent or provide a basis for refusing to pay him his capital interest. Thus, Persky manipulated the Buckley settlement, Kayne and Sloane instituted a $3,000,000 fraud suit in California (the court found the damages were an *in terrorem* figure), and Ned Frank (a general partner) prepared a list of alleged instances of malfeasance by Gross, six of which were asserted as counterclaims against Gross in this litigation. A further lever used against Gross was the denial of the Rafkind opportunity. Judge Owen found that the "direct and circumstantial proof is quite clear that all the foregoing was participated in by all [of the promoters, except Berkowitz,] acting out of the single motive to force Gross into accepting [their] dictates." Further, the court found that when the threats failed, the promoters decided to proceed with the transfer "in knowing

violation of Section 98," and "based upon Persky's worthless opinion letter." The court found that Persky, Risher, Muh, Kayne and Sloane "were actively participating, knowing what each was doing and hoping to reap substantial benefits from this joint conduct."

As for the general partners, the court found that, motivated by the promise of debt forgiveness and the desire to salvage their interests in the firm, they "lent themselves to the goals of this conspiracy by affirmatively permitting the Partnership to transfer its assets to the Corporation in violation of Section 98 of the Partnership Law and in violation of their fiduciary duties to Gross, Bleich and Donoghue as other partners, and by their knowing acquiescence in the use by the [promoters] of the various baseless litigation threats against Gross." Accordingly, the court held the Corporation and the additional defendants on the counterclaims[12] jointly and severally liable on defendants' first, second, and fourth counterclaims for the "wrongful conversion" of the capital of Gross, Bleich and Donoghue. The court awarded Donoghue and Bleich each $76,868, and awarded Gross $337,921.[13]

Judge Owen also found for Gross on defendants' third counterclaim, which Judge Ward had held could be asserted only as a set-off. This claim alleged that in 1970 the Partnership had distributed to the partners as profits an

12. As noted, the court dismissed the counterclaims as to Berkowitz and Aixala, see text and notes at 1-2, supra, and as used here the terms "additional defendants" do not apply to them.

13. The sum of $75,868 represented the initial capital investments of Bleich and Donoghue of $75,000, plus $1,868 owing as interest as of December 31, 1970. The court found an accounting would have shown Gross' capital interest on February 11, 1971, to be $337,921.

interest in certain stock warrants, which the record indicates were earned by the Partnership in 1969. These warrants were never physically distributed but were held in the Partnership's name and were transferred to the Corporation as part of the Partnership's assets. The court found that Gross did own an interest in the warrants and that the Corporation, Kayne, Risher, Persky and Finley, Kumble were liable in the sum of $58,368 and $75,803 for the willful conversion of Gross' interest in the warrants.[14] Although Judge Owen noted that Judge Ward had ruled that the third counterclaim could only be asserted as a set-off, he held that this claim had been fully litigated and ordered that the pleadings be amended to conform to the proof.

Further, Judge Owen awarded Gross $50,000 in punitive damages against the Corporation, Kayne, Risher, Persky and Finley, Kumble.[15] Although he indicated that the non-competition clause in the Partnership articles had been asserted against Gross without "economic justification," he found that the Partnership "had the legal right to assert" the clause. Judge Owen concluded that the alleged destruction of the Rafkind opportunity did not state a cause of

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14. The court found that Kayne, Risher and Persky had conspired to "purloin" and had accomplished the purloining of the securities by placing them in a secret vault to ensure they would be transferred to the Corporation. Since we dismiss the third counterclaim on jurisdictional grounds, we need not examine the merits of these findings.

15. Muh and Sloane were listed among those parties held liable for conversion of the warrants and for punitive damages in the final judgment entered on September 1, 1976. However, in an order filed on November 18, 1976, Judge Owen stated that Sloane and Muh had been added to that part of the judgment dealing with damages for conversion of the warrants and punitive damages by inadvertence and ordered their names deleted therefrom. See Fed. R. App. P. 10(e).

action and dismissed the defendants' ninth (antitrust) counterclaim. Finally, as for the six counterclaims asserted against Gross, four were abandoned at trial and Judge Owen dismissed the remaining two claims on the merits.[16] Final judgment was entered on September 1, 1976.

The Corporation appeals from the dismissal of its churning claims. Defendants appeal from the dismissal of their fifth, sixth, seventh, eighth and ninth counterclaims. The Corporation and most of the additional defendants on the counterclaims appeal from the judgments entered against them on defendants' first, second, third[17] and fourth counterclaims and for punitive damages.[18]

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16. Although at one point the Corporation suggests that the court erred in dismissing the claim that Gross engaged in "secret trading" while managing partner, it concedes that the court's decision was not "plainly erroneous"—apparently in reference to Fed. R. Civ. P. 52(a). Neither the Corporation nor any of the additional defendants have stated any basis for disturbing the dismissal of their counterclaims against Gross; accordingly, this portion of the district court's opinion is affirmed.

17. In the final judgment entered by Judge Owen on September 1, 1976, he found for Gross on the claim of conversion of the stock warrants but actually dismissed the third counterclaim for lack of jurisdiction. Apparently, Judge Owen found that the claim of conversion of the warrants was included in the second counterclaim; thus, in his opinion of July 7, 1976, Judge Owen stated that this claim was "arguably pleaded" in the second counterclaim. Since we have found that the court lacked jurisdiction over this claim, it makes little difference whether it is denominated the third counterclaim or part of the second counterclaim. We have used the term "third counterclaim" for purposes of clarity.

18. Three of the additional defendants on the counterclaims—John F. Settel, Harold J. Richards, and the estate of Ned D. Frank—who were held jointly and severally liable to Gross, Donoghue and Bleich for their capital interests in the Partnership, have not filed notices of appeal or participated in this appeal. Accordingly, the judgment of the district court insofar as it relates to these additional defendants is not before this court, see 28 USC §1291; Fed. R. App. P. 3, 4.

Appendix A

I. *The Churning Claim*

The Corporation argues that Judge Owen's finding that the Buckley account was not churned is clearly erroneous. "Churning" occurs when a securities dealer abuses his customer's confidence for personal gain (e.g. to create commissions) by inducing transactions in the customer's account which are disproportionate to the size and character of the account. Churning has been held to be a deceptive device within §10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, for which a private cause of action for damages will lie. See, e.g., *Ruskay* v. *Waddell,* 552 F.2d 392, 393 n.2 (2d Cir. 1977); *Carras* v. *Burns,* 516 F.2d 251, 258 (4th Cir. 1975); *Landry* v. *Hemphill, Noyes & Co.,* 473 F.2d 365, 368 n.1 (1st Cir.), cert. denied, 414 U.S. 1002 (1973); *Hecht* v. *Harris, Upham & Co.,* 430 F.2d 1202, 1206-07 (9th Cir. 1970); *Powers* v. *Francis I. DuPont & Company,* 344 F. Supp. 429, 431 (E.D. Pa. 1972); *Moscarelli* v. *Stamm,* 288 F. Supp. 453, 457 (E.D.N.Y. 1968); see generally Note, Churning by Securities Dealers, 80 Harv. L. Rev. 869 (1967). In order to recover, the customer must show that the dealer effectively exercised control over trading in the account and manipulated the account to his benefit. Where, as here, the account is non-discretionary (i.e., the dealer may not make trades in the account without the customer's authorization), the plaintiff must show that he relied extensively on his broker's advice and that the broker abused the plaintiff's trust. Thus, if a customer is fully able to evaluate his broker's advice and agrees with the broker's suggestions, the customer retains control of the account. See *Carras* v. *Burns,* supra, 516 F.2d at 258-59.

Appendix A

In essence, the Corporation contends that the Buckley account was excessively traded by Jordon in order to generate commissions and that, at least on one occasion, Jordon gave Buckley false information. The short answer to this contention, however, is that the evidence in this area was conflicting and Judge Owen's conclusion is amply supported by the record.

It is evident from David Buckley's testimony that he is an intelligent, well-educated man with a Bachelor's Degree from Cornell University, where he majored in Economics, and a post-graduate degree in International Marketing. When Buckley opened his account with Gross & Co. he was thirty-one years old and had prior experience in the market. He testified that he spent over $100 per month on investment advisory services, in addition to subscribing to various financial journals. Buckley frequently communicated with Jordon by telephone concerning his account and testified that he was "intensely interested" in the account. According to Buckley, as many as eighty or ninety per cent of the transactions in the account occurred as a result of Jordon's suggestions; however, Jordon testified that Buckley initiated at least as many transactions as he did. In any case, Buckley authorized every transaction that took place and he testified he frequently rejected Jordon's recommendations.

The Corporation contends that the turnover ratio—the ratio of the total cost of purchases to the amount invested —averaged seven times per year and that the total amount of commissions generated was approximately $75,000. While these factors may serve as useful indicators, see, e.g., *Carras* v. *Burns*, supra, 516 F.2d at 258, they must be

examined in light of the character of the account. As Judge Owen found, the evidence shows that Buckley was interested in speculation and a greater volume of activity will normally be expected in such an account. See, e.g., *Landry* v. *Hemphill, Noyes & Co.*, supra, 473 F.2d at 374; Note, supra, 80 Harv. L. Rev. at 875. The expert testimony regarding the significance of this evidence was conflicting.

In sum, the determination of whether Buckley exercised control over the account involved a question of fact, which turned largely upon the court's assessment of the witnesses' credibility and its judgment regarding Buckley's ability to evaluate the advice given to him by Jordon. Such issues are particularly the province of the trier of fact and Judge Owen's conclusion was not clearly erroneous. See Fed. R. Civ. P. 52(a).

II. *The Counterclaims*

A. *Jurisdiction*

The Corporation and the addititional defendants on the counterclaims contend that the court erred in finding that the defendants' first, second and four state law counterclaims were compulsory counterclaims within the court's ancillary jurisdiction. It is well-established that counterclaims that are "compulsory" within the meaning of Fed. R. Civ. P. 13(a) are within the district court's ancillary jurisdiction and, thus, require no independent basis of federal jurisdiction. See, e.g., *Moor* v. *County of Alameda*, 411 U.S. 693, 714-15 (1973); *United States* v. *Heyward-Robinson Company*, supra, 430 F.2d at 1080-81; *United*

Artists Corp. v. *Masterpiece Productions,* 221 F.2d 213, 216 (2d Cir. 1955); further, if a counterclaim is compulsory, the district court's ancillary jurisdiction extends to third parties (in this case the additional defendants) whose presence is required for adjudication of the counterclaim. See *Moor* v. *County of Alameda,* supra, 411 U.S. at 714-15; *United Artists Corp.* v. *Masterpiece Productions,* supra, 221 F.2d at 216-17.

On the other hand, the district court has no jurisdiction over a permissive counterclaim, see Fed. R. Civ. P. 13(b), unless it rests upon an independent jurisdictional ground. *United States* v. *Heyward-Robinson Company,* supra, 430 F.2d at 1080-81; *O'Connell* v. *Erie Lackawanna R.R. Co.,* 391 F.2d 156, 163 (2d Cir. 1968), vacated as moot, 395 U.S. 210 (1969); *Lesnik* v. *Public Industrials Corporation,* 144 F.2d 968, 976 n.10 (2d Cir. 1944). Although there has been some criticism of the requirement of an independent jurisdictional ground for permissive counterclaims, see *United States* v. *Heyward-Robinson Company,* supra, 430 F.2d at 1087-88 (Friendly, *J.*, concurring); Green, Federal Jurisdiction over Counterclaims, 48 N.W.U.L. Rev. 271 (1953), the cases have uniformly adhered to this requirement. See *Sue & Sam Mfg. Co.* v. *B-L-S Const. Co.,* 538 F.2d 1048, 1051 (4th Cir. 1976); *Pipeliners Local Union No. 798, Tulsa, Okl.* v. *Ellerd,* 503 F.2d 1193, 1198 (10th Cir. 1974); 6 Wright and Miller, Federal Practice and Procedure, §1414 (1971).[19] At their core, the compulsory counterclaim doctrine and the parallel doctrine of ancillary

19. The parties are in agreement with respect to the applicability of this rule and have not asked us to examine its continuing validity. Accordingly, we refrain from undertaking such an examination.

jurisdiction both seek to further the same policy, which is to avoid piecemeal litigation in the federal courts. See, e.g., *United States* v. *Heyward-Robinson Company,* supra, 430 F.2d at 1082; *Great Lakes Rubber Corporation* v. *Herbert Hoover Company,* 286 F.2d 631, 633-34 (3rd Cir. 1961); *United Artists Corp.* v. *Masterpiece Productions,* supra, 221 F.2d at 216-17. Since a compulsory counterclaim is by definition closely related to the subject matter of the opposing party's claim, common sense and judicial economy compel the conclusion that such claims should be tried together and the extension of ancillary jurisdiction to compulsory counterclaims is consistent with Article III's grant of jurisdiction over "cases" arising under the Constitution and federal laws. See *Aldinger* v. *Howard,* 427 U.S. 1, 6-16 (1976); 6 Wright and Miller, supra, at §1414.

Fed. R. Civ. P. 13(a) provides, *inter alia,* that a counterclaim is compulsory, "if it arises out of the transaction or occurrence that is the subject matter of the opposing party's claim." In interpreting this language we have adopted what has been termed the "logical relation" test. See 6 Wright and Miller, supra, at §1410. Thus, in *United Artists Corp.* v. *Masterpiece Productions,* supra, 221 F.2d at 216, Chief Judge Clark said, "In practice this criterion has been broadly interpreted to require not an absolute identity of factual backgrounds for the two claims, but only a logical relationship between them."[20]

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20. In *United Artists* we relied on our earlier holding in *Lesnick* v. *Public Industrials Corporation,* supra, which relied, in turn, upon *Moore* v. *New York Cotton Exchange,* 270 U.S. 593 (1926). There, in interpreting the scope of Equity Rule 30, the Supreme Court stated, " 'Transaction' is a word of flexible meaning. It may comprehend a series of many occurrences, depending not so much upon the immediateness of their connection as upon their logical relationship." Id. at 610.

Applying this standard, Judge Ward found that the controversy surrounding the sale of assets to the Corporation had "become inextricably intertwined" with the Corporation's churning claims. *Newburger, Loeb & Co., Inc.* v. *Gross,* supra, 365 F. Supp. at 1367. He concluded that defendants' first and second counterclaims were so closely tied to its defenses to the Corporation's claims that they were "logically related" to those claims and that since the fourth counterclaim asserted the same allegedly wrongful acts, it too should be considered a compulsory counterclaim. We agree with Judge Ward's findings and note that the evidence at trial demonstrates the soundness of his ruling.

Essentially, the defendants asserted two defenses to the Corporation's churning claims. First, they contended that the February 11 transfer, which included the transfer of the Buckley claim from the Partnership to the Corporation, was ineffective because conducted in violation of New York Partnership Law §98; accordingly, they contended that the Corporation could not press the Buckley claim because it did not own it. Second, the defendants claim that the Corporation was estopped from asserting the claim because it was brought as part of a conspiracy against them in violation of the fiduciary duties owed to them; thus, the defendants alleged, *inter alia,* that the Buckley claim was taken by the Partnership in bad faith for the sole purpose of creating a colorable claim against them, that the transfer of assets was induced by "fraudulent special consideration" as part of a plot by Kayne, Muh and Risher to gain control of the Partnership's assets, and that the transfer itself was in violation of fiduciary duty.

Appendix A

It is obvious that there was a substantial overlap between the defendants' defenses and their first, second, and fourth counterclaims; indeed, proof of these defenses was tantamount to establishing defendants' case on their counterclaims. To require the defendants to assert these defenses against the Corporation and then bring a separate action on their counterclaims in state court would amount to considerable duplication of judicial time and effort and could lead to mutually inconsistent results. Thus, in a similar situation this court held that where the plaintiff brought suit upon a note and the defendant counterclaimed on the ground that the suit was part of a broader conspiracy to injure its business, the counterclaims should be viewed "as arising out of the occurrence, and surely out of the transaction, by which [plaintiff] took the note upon which his complaint was based." *Lesnik* v. *Public Industrials Corporation,* supra, 144 F.2d at 975. Further, Judge Clark, speaking for the court. found that "proof of the conspiracy bears directly upon [plaintiff's] allegation of due and proper assignment of the note to him and should be here tried, to avoid multiplicity of suits and secure economy of judicial action." Id. at 975. See *United Artists Corp.* v. *Masterpiece Productions,* supra, 221 F.2d at 216. In sum, we find that defendants' first, second and fourth counterclaims arose out of the series of assignments upon which the Corporation's claims are based and that "the pleadings disclose a sufficient logical relationship so that, in the interest of avoiding circuity and multiplicity of action, [these counterclaims] should be considered compulsory." *United Artists Corp.* v. *Masterpiece Productions,* supra, 221 F.2d at 216.

We further conclude that defendants' fifth, sixth and seventh counterclaims were correctly dismissed for lack of subject matter jurisdiction. These claims alleged that under the terms of the Partnership agreement Gross, Bleich and Donoghue were entitled to the return of their capital interests; apparently, these claims were based on the theory that the Partnership had effectively dissolved. We can find no significant relationship between these contract claims and the substance of the Corporation's claims or the assignment of the churning claim to the Corporation. In any case, the successful assertion of defendants' first, second and fourth counterclaims has effectively made moot any claim for damages on the fifth, sixth and seventh counterclaims.

Judge Ward's holding that the court lacked ancillary jurisdiction over defendants' eighth counterclaim (which was followed by Judge Owen), presents a somewhat closer question. This claim alleged that the Corporation and the additional defendants had "wrongfully and maliciously" brought about the destruction of Gross' opportunity for employment with Rafkind & Co. by informing it of the restrictive covenant in the Partnership agreement. Essentially, this claim presented a state law issue of whether the restrictive covenant was reasonable as to time and area and necessary to protect legitimate interests. See *Gelder Medical Group* v. *Webber,* 41 N.Y.2d 680, 683 (1977). Unlike defendants' first, second and fourth counterclaims, resolution of this issue was largely unrelated to the validity of the assignment of the Buckley claim to the Corporation; indeed, even if the restrictive covenant was exercised solely

as a coercive tactic, as defendants' alleged, it is not clear that this would affect the validity of the covenant if it was otherwise enforceable under state law. See id. at 684. Although the use of the restrictive covenant against Gross tended to support the defendants' claim of breach of fiduciary duty, we conclude that Gross' claim that the exercise of the clause was an independent violation of state law was not sufficiently related to the Corporation's claims to render it a compulsory counterclaim.

The Corporation and certain of the additional defendants argue that Judge Owen erroneously granted Gross relief on defendants' third counterclaim after Judge Ward had held that this claim was not within the ancillary jurisdiction of the court and could be asserted only as a set-off. We agree.

The third counterclaim presented the issue of whether an interest in certain stock warrants had been distributed as profits to Gross under the Partnership agreement and, thus, whether this interest was converted when the warrants were transferred to the Corporation as part of the Partnership assets. It is undisputed that the warrants were at all times held by the Partnership, in the Partnership's name, and were never physically distributed. The basic issue was simply whether the Partnership could (consistently with the Partnership agreement) and did distribute to the general partners interests in the warrants. There was simply no logical relation, either in law or in fact, between proof of this counterclaim and proof of the Corporation's churning claim; indeed, had the transfer of assets never taken place, this would not have affected the

basic nature of Gross' claim for possession of the warrants. Further, we fail to see how Judge Owen's amendment of the pleadings to conform to the proof could overcome this basic jurisdictional defect. See Fed. R. Civ. P. 82. Accordingly, we reverse the judgment insofar as it grants relief on defendants' third counterclaim.[21]

Finally, defendants claim that irrespective of the doctrine of ancillary jurisdiction, all of their counterclaims were properly before the court because their first eight counterclaims were pendent to their ninth counterclaim, which rests upon the federal antitrust laws. With the exception of defendants' eighth counterclaim, discussed infra, we think defendants' reliance on the doctrine of pendent jurisdiction is without merit. The test for the presence of pendent jurisdiction was formulated by the Supreme Court in *United Mine Workers* v. *Gibbs*, 383 U.S. 715 (1966) as follows:

> The state and federal claims must derive from a common nucleus of operative fact. But if, considered without regard to their federal or state character, a plaintiff's claims are such that he would ordinarily be expected to try them all in one judicial proceeding, then, assuming substantiality of the federal issues, there is *power* in federal courts to hear the whole.

Id. at 725 (footnote omitted).

The operative facts of the antitrust claim were simply whether the enforcement of the restrictive covenant vio-

21. We note that under the tolling provisions applicable to the state statute of limitations, it would appear that defendants are free to bring a separate action on their third and eighth counterclaims in state court, without fear of the limitations period having run during the pendency of this suit. See CPLR §205.

lated the federal antitrust laws. In contrast, defendants' first through seventh counterclaims involved issues of state partnership and tort law, and interpretation of the partnership agreement and the distribution of profits under it, all of which were dependent upon proof of facts that were entirely irrelevant to the antitrust claim. Such claims would not ordinarily be tried together and the only common link between these claims—the allegation that enforcement of the restrictive covenant was part of a larger conspiracy involving the transfer agreement—simply does not provide the "common nucleus of operative fact" essential to the exercise of pendent jurisdiction.

B. *Defendants' First, Second and Fourth Counterclaims Liability.*

The Corporation and the additional defendants raise numerous claims of error regarding Judge Owen's finding that they were each liable on defendants' first, second and fourth counterclaims for conspiring "to injure Gross, Bleich and Donoghue in their interests in the Partnership," which may be summarized as follows: first, the Corporation and the additional defendants claim that under New York law there is no tort of "conspiracy" and it was incumbent upon defendants to prove that each individual sought to be held liable knowingly participated in some actionable wrong; second, they claim that no actionable wrong was suffered by Gross, Bleich or Donoghue; and, third, that if any such wrong was committed, they did not knowingly participate in it.

Appendix A

At the outset, the significance of an allegation of conspiracy under New York law is to charge that an actionable wrong was committed jointly by the defendants so that the acts of one may be imputed to the others because of their common purpose and intent. See *Original Ballet Russe* v. *Ballet Theatre, Inc.*, 133 F.2d 187, 189 (2d Cir. 1943); *A. S. Rampell, Inc.* v. *Hyster Co.*, 3 N.Y.2d 369, 379 (1957); *Green* v. *Davies*, 182 N.Y. 499, 504 (1905); *Dalury* v. *Rezinas*, 183 App. Div. 456, 459-60 (1st Dept. 1918), aff'd, 229 N.Y. 513 (1920). "The allegation of conspiracy carries no greater burden, but also no less, than to assert adequately common action for a common purpose by common agreement or understanding among a group, from which common responsibility derives." *Goldstein* v. *Siegel*, 19 App. Div. 2d 489, 493 (1st Dept. 1963) (Breitel, *J.*).

Judge Owen found that Kayne, Risher, Sloane and Muh, guided by Persky, had engaged in a plot to gain control of the assets of the Partnership in the course of which they participated in at least two separate wrongs to the defendants: (1) the "knowing" violation of Donoghue and Bleich's rights as limited partners under section 98, which he found to be a conversion of their capital interests in the Partnership; and, (2) the violation by the members of the Partnership of the fiduciary obligations owed to Gross, Bleich and Donoghue. Thus, Judge Owen found that the partners had lent themselves to the goals of the promoters' plan by "affirmatively permitting" the transfer to take place in violation of section 98, and by their "knowing acquiescence" in the promoters' use of "various baseless litigation threats." We hold that these findings are supported by the record and are sufficient in law to im-

pose liability upon the Corporation and the additional defendants, both on a conspiracy theory and on the related principle that one who knowingly participates with a fiduciary in a breach of trust is liable to the beneficiary for any damage caused thereby. See *Wechsler* v. *Bowman,* 285 N.Y. 284, 291, modified, 286 N.Y. 582 (1941); 5 Scott on Trusts, §506 (3rd ed. 1967).

Turning first to the claims of Donoghue and Bleich, we agree with Judges Ward and Owen that the transfer of the Partnership assets without the consent of Donoghue and Bleich was a violation of section 98 of New York Partnership Law. See, e.g., *Executive Hotel Associates* v. *Elm Hotel Corporation,* 41 Misc. 2d 354 (Civ. Ct. City of New York), aff'd 43 Misc. 2d 153 (App. Term, 1st Dept. 1964). The February 11 transfer effectively terminated the Partnership and funneled its assets into a new entity. It is difficult to conceive of an act that would make it more "impossible to carry on the ordinary business of the partnership." Partnership Law, §98(1)(b). Relying on *Mist Properties, Inc.* v. *Fitzsimmons Realty Co.,* 228 N.Y.S. 2d 406 (Sup. Ct. Kings County 1962), Persky argues that the transfer did not violate section 98 because the partnership agreement provided that the general partners could terminate the partnership prior to its natural expiration date and delegated to the general partners the authority to manage the business. We disagree.

Mist Properties held that a transfer of the partnership property by general partners, without the consent of the limited partners, did not violate section 98(1)(b) where the partnership agreement "specifically contemplated and

provided for" the transfer that took place. Id. at 410. Judge Ward rejected the argument that the rights of limited partners under section 98(1)(b) could be abrogated by the partnership agreement on the grounds that "[t]his section, by its terms, is absolute and not subject to variation by agreement of the parties." *Newburger, Loeb & Co., Inc.* v. *Gross,* supra, 365 F.Supp. at 1369. However, there is simply no language in the Partnership agreement that can be construed as granting the general partners the right to conduct the February 11 transfer; indeed, this is the precise conclusion reached by the Rosenman, Colin memorandum of January 25, 1971, discussed supra. The February 11 transfer did not merely terminate the Partnership (which, in fact, is what Gross, Bleich and Donoghue sought by liquidation), it transferred all of the Partnership assets, including the capital interests of Bleich and Donoghue, to an entirely new entity, with new management and different rights between the parties. This drastic change in the rights and relations of the parties went far beyond any powers granted the general partners to terminate or manage the business. Bleich and Donoghue were under no obligation to consent to the transfer and were entitled to insist that the Partnership be dissolved. See Partnership Law, §99(1)(c).

We also reject Persky's claim that the transfer was "necessary" to enable the Partnership to carry on its business and that section 98(1)(b) does not apply to partnerships in "financial distress." We think Judge Ward correctly dismissed these arguments as plainly contrary to the language and intent of the statute. See *Newburger, Loeb & Co., Inc.* v. *Gross,* supra, 365 F. Supp. at 1369-70.

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Judge Owen found that the promoters, guided by Persky, caused the transfer to take place "in knowing violation of Section 98" and that the partners participated in the transfer and permitted it to go forward "in knowing contravention" of section 98. Since the transfer of assets was in violation of section 98, the unauthorized exercise of dominion over the capital interests of Bleich and Donoghue by the Corporation amounted to conversion.[22] See *McCoy* v. *American Express Co.*, 253 N.Y. 477, 482 (1930); *Suzuki* v. *Small*, 214 App. Div. 541, 556 (1st Dept. 1925), aff'd, 243 N.Y. 590 (1926). Further, by causing the transfer to take place in knowing violation of section 98, the partners wrongfully appropriated the capital interests of Bleich and Donoghue and were liable to them in an action for an accounting.[23] See, e.g., *Bassett* v. *American Meter Co.*, 20

22. As noted, the effect of the transfer was to terminate the Partnership and convey its assets to a new entity. Although as a general proposition, limited partners have no property right in the partnership assets, see, e.g., *Alley* v. *Clark*, 71 F. Supp. 521, 526-28 (E.D.N.Y. 1947), Bleich and Donoghue had a capital investment in the Partnership and upon its termination had the right to demand their appropriate share of the assets. Thus, we conclude that at the time of the transfer Bleich and Donoghue had a possessory interest in specific moneys, which was wrongfully converted.

23. Although Judge Owen's finding of conversion against the non-partner additional defendants was proper, see *Mannaberg* v. *Herbst*, 45 N.Y.S.2d 197, 201 (Sup. Ct. N.Y. County 1943), aff'd, 267 App. Div. 818 (1st Dept.), aff'd, 293 N.Y. 657 (1944), it is unclear whether the partners could be sued in an action at law for conversion. As a general rule, in a going partnership a partner may not sue another partner at law for conversion of or injury to partnership property and is limited to an action in equity for an accounting. See *Bassett* v. *American Meter Co.*, 20 App. Div.2d 956, 957 (4th Dept. 1964); *Dalury* v. *Rezinas, supra*, 183 App. Div. at 460. This rule is based upon the convenience of the parties, the fact that equitable relief may

(footnote continued on next page)

App. Div. 2d 956, 957 (4th Dept. 1964); *Sohon* v. *Rubin*, 282 App. Div. 691 (1st Dept. 1953); *Hasday* v. *Barocas*, 10 Misc. 2d 22, 25-26 (Sup. Ct. N.Y. County 1952). The promoters (who also acted as officers of the Corporation) and Persky were properly held liable for causing the wrongful appropriation of the capital interests of Bleich and Donoghue, see, e.g., *Mannaberg* v. *Herbst*, 45 N.Y.S.2d 197, 201

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be necessary to protect the rights of the parties, and the notion that only after a balance has been struck can the relative rights of the parties be definitively established. See, e.g., *Bassett* v. *American Meter Co.*, supra; Crane and Bromberg, *Law of Partnership*, §69 (1968). However, where the partnership has terminated and the plaintiff seeks to recover for a wrong to his individual interest, as here, the rule against actions at law has not always applied. See *Mannaberg* v. *Herbst*, supra, 45 N.Y.S. at 199; Crane and Bromberg, supra, §69.

However, even assuming that Gross, Bleich and Donoghue could not bring an action at law against the partners, we do not think that because Judge Owen stated that the partners were guilty of "converting" the Partnership interests of the defendants, his finding of liability on defendants' first, second and fourth counterclaims must be reversed.

The first and second counterclaims alleged that the Corporation and the additional defendants were required to account for the capital interests of the defendants and should be held as constructive trustees. The grounds upon which an accounting was sought were breach of fiduciary duty and Judge Owen specifically found that the partners had breached their fiduciary obligations by permitting the transfer to go through in violation of section 98 and by furthering the goals of the conspiracy initiated by the promoters. This inquiry was the proper subject of the accounting requested by the defendants. See *Bassett* v. *American Meter Co.*, supra, 20 App. Div. 2d at 957; Crane and Bromberg, supra, §72 at 411. We find that Judge Owen correctly concluded that the transfer and the events leading up to it constituted a violation of the fiduciary duties owed to the defendants and, for reasons discussed infra, we remand for a determination of what an accounting would show to be the capital interests of the defendants as of February 11, 1971. There are no significant differences between this procedure and an accounting in equity and we reject the additional defendants' claim that Judge Owen erred in finding the partners liable for "coversion." Cf. *Shon* v. *Rubin*, 282 App. Div. 691, 692 (1st Dept. 1953) (trial court's finding of conversion against defendant partner was improper but plaintiffs awarded the amount an accounting would have shown them entitled to).

(Sup. Ct. N.Y. County 1943), aff'd, 267 App. Div. 818 (1st Dept.), aff'd, 293 N.Y. 657 (1944), and for participating in the partners' breach of trust. See *Wechsler* v. *Bowman,* supra, 285 N.Y. at 291; *Mannaberg* v. *Herbst,* supra, 45 N.Y.S.2d at 201.

The partners, promoters and Persky argue that they cannot be held liable to Bleich and Donoghue if they believed in good faith that the transfer was not in violation of their rights. Assuming this to be so, we find there was ample evidence to support Judge Owen's finding that they caused the transfer to go forward in knowing violation of the rights of Donoghue and Bleich.

Turning first to the promoters and Persky, the record indicates that at least by January 15, 1971, Persky, Risher, and Muh had been informed by counsel to Donoghue and Bleich that it was their position that the transfer could not be legally accomplished without their consent. By January 25, 1971, the Rosenman, Colin firm, acting as counsel to the Partnership, had prepared a memorandum concluding that under section 98(1)(b) the transfer could not go forward without the consent of all of the limited partners; their memorandum specifically rejected Persky's main argument on appeal—that the consent of Bleich and Donoghue was not necessary under *Mist Properties.* Burak testified that around the time the memorandum was prepared he told Persky that his firm had concluded that the consent of all of the limited partners was necessary and gave Persky either a copy of the memorandum or the relevant citations. It is uncontroverted that in a letter to all counsel, dated February 2, 1971, Persky stated that he

had been advised that Bleich would not consent to the transfer and that "[u]nless we are advised in writing that Miss Bleich will consent . . . our plans to close on February 11, 1971 will be cancelled and . . . [the Partnership] will be liquidated."

Burak testified that on February 10, 1971, Persky unsuccessfully attempted to persuade the Rosenman, Colin attorneys to issue a favorable opinion. Judge Owen found that at the February 11 closing Persky "professed astonishment" when the Rosenman, Colin attorneys announced that they would not issue the opinion letter.[24] Although Persky represented the Corporation at this time, he nevertheless acted as "special counsel" to the Partnership and issued an opinion letter which Judge Owen characterized as "worthless."

The record demonstrates that Persky, Kayne, Sloane, Risher and Muh were in close communication. At the same meeting that counsel for Gross, Bleich and Donoghue told Persky, Risher and Muh that the transfer could not be conducted without their consent, Gross was told that if

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24. Finley, Kumble argues that the opinion letter was immaterial because the condition of its issuance could have been waived by the Corporation and because Gross, Bleich and Donoghue did not rely on the letter. This argument simply misconceives the importance of the letter as one of the steps in the plot to gain control of the Partnership assets. Judge Owen found that the letter was an "essential document" to the closing and this finding is supported by the testimony of Robert D. Steefel, counsel to one of the limited partners; he testified that he and the other attorneys representing the limited partners stated at the closing that the transaction could not be completed without the opinion letter. Similarly, Muh testified that on the night of the closing Berkowitz told him "that we have to have an opinion letter." Thus, as a practical matter, it appears that the deal would not have gone through unless a letter of opinion was issued.

he wanted to avoid being sued he should go along with the transfer and convince Bleich and Donoghue to do so. Gross refused to comply and shortly after this meeting concluded Kayne and Sloane called Gross from California and renewed the threats. On January 23, Kayne met with Gross and again threatened him. Bleich testified that some time in January Risher threatened her with the Buckley claim in an attempt to coerce her consent. On February 3, 1971, the day after Persky had sent out the letter indicating that the transfer would be cancelled if Bleich did not consent, Kayne and Sloane brought suit in California. There was evidence that other threats were made as the closing date drew nearer but we think that the evidence we have summarized is sufficient to support Judge Owen's conclusion that Persky, Kayne, Risher, Muh and Sloane believed that the consent of Donoghue and Bleich was necessary to the transfer and conspired to coerce the necessary acquiescence. When this plan failed they proceeded with the transfer, as promoters, officers, and counsel to the Corporation, in knowing violation of the rights of Donoghue and Bleich.

As to the liability of the partners, the Partnership had been informed by Burak that the transfer could not be conducted without the consent of Bleich and Donoghue; Burak specifically discussed the matter with Andrew Newburger and Persky. Thereafter, Persky sent out a letter to counsel stating that if Bleich did not consent, the transfer would be cancelled. On the date of the closing Rosenman, Colin refused to issue an opinion letter stating that the Partnership had the authority to make the transfer. Judge Owen

specifically rejected the argument that the partners simply went along with the transfer based on the advice of other counsel present. In this regard, it is significant that the record is devoid of any testimony by any of the defendant partners that they believed in the correctness of Persky's opinion and disbelieved the advice of their own counsel and that, in its final form, the transfer agreement provided that the Corporation accepted liability for the claims of Gross, Bleich and Donoghue. Judge Owen concluded that "the partners consenting did so as a matter of business judgment having been forgiven substantial capital arrears and hoping that the transfer to the Corporation would save their deeply threatened interests . . . they were prepared to accept the letter Persky proposed and delivered and the risks of illegality which went with it as a deliberate business choice." We conclude that the findings of Judge Owen in this regard were not clearly erroneous.

A number of the additional defendants argue that even if the transfer violated section 98, judgment as to Gross on the first, second and fourth counterclaims must be reversed because he had no standing as a withdrawn general partner to complain of the violation. The additional defendants contend that section 98 protects only limited partners and that under the terms of the partnership agreement, the Partnership or its successor had the right to retain and use Gross' capital for a period of twelve months from the effective date of his withdrawal (until September 30, 1971). Gross contends that, even if this argument is correct, the finding of liability must be affirmed because the transfer and the events leading up to it constituted a

breach of fiduciary duty, entitling him to a return of his capital interest in the Partnership. We agree.[25]

Essentially, the issue before Judge Owen was whether the misconduct on behalf of the partners was sufficient to entitle Gross to terminate his obligations under the partnership agreement and have his share of the transferred assets returned—that is, in effect, to have a decree of dissolution and an accounting effective February 11, 1971. See Partnersip Law, §§62, 63; Crane and Bromberg, *Law of Partnership*, §78(c)(1968); note 22, supra.

Although there is no set formulation of the fiduciary duties of partners, the main elements of the obligations owed by one partner to another have been defined as "utmost good faith, fairness, loyalty." Crane and Bromberg, supra, §68, at 390. In *Meinhard* v. *Salmon*, 249 N.Y. 458 (1928), Chief Judge Cardozo described the obligations of co-partners as follows:

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25. The parties have expended considerable effort disputing what Judge Owen actually found. The additional defendants contend that the award to Gross was based on a finding of conversion and not upon breach of fiduciary obligation. Although Judge Owen did not specify which allegations in defendant's first, second and fourth counterclaims he was relying on, the theory of breach of fiduciary obligation was clearly presented to him. Judge Owen laid out in detail the conspiracy by the promoters to grasp control of the Partnership assets and found that the partners had violated their fiduciary duties to Gross, Bleich and Donoghue by permitting the conspiracy to reach fruition and lending themselves to its goals. See note 22, supra. Aside from this conclusion of law, we find that the facts as found by Judge Owen independently support a finding of breach of fiduciary obligation. Thus, even had Judge Owen not specifically found a breach of duty, Gross would not be barred from raising this claim on appeal. See, e.g., *Dandridge* v. *Williams*, 397 U.S. 471, 475 n.6 (1970) ("The prevailing party may, of course, assert in a reviewing court any ground in support of his judgment, whether or not that ground was relied upon or even considered by the trial court"); *Ajax Hardware Manufacturing Corp.* v. *Industrial Plants Corp.*, No. 75-7663, slip op. 4703, 4710 n.3 (2d Cir. July 13, 1977).

> Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.

Id. at 464 (citations omitted).

Further, although Gross withdrew from the Partnership, effective September 30, 1970, this did not terminate the fiduciary obligations of the partners to him; indeed, as a withdrawn general partner Gross no longer had any voice in management, although his capital remained in the firm at the risk of the business and Gross continued to share in an allocated portion of the firm's profits and losses. Thus, we conclude that at least up to and perhaps after the transfer, the Partnership and its members owed to Gross the duties of good faith, fairness and loyalty in their dealings with him regarding the Partnership business. See, e.g., Partnership Law §43(1); *R. C. Gluck & Co., Inc.* v. *Tankel,* 24 Misc. 2d 841, 846 (Sup. Ct. N.Y. County 1960), aff'd, 12 App. Div. 2d 339 (1st Dept. 1961); *Boxill* v. *Boxill,* 201 Misc. 386, 391 (Sup. Ct. N.Y. County 1952); *Pearlstein* v. *Baff,* 60 N.Y.S.2d 713 (Sup. Ct. Queens County), rev'd on other grounds, 270 App. Div. 1043, mod-

ified, 271 App. Div. 834 (2d Dept. 1946), aff'd, 296 N.Y. 881 (1947).

Judge Owen found that the promoters threatened Gross with baseless litigation in order to force him to go along with the transfer. In making such threats Kayne, Sloane, Muh, Risher and Persky were acting in various capacities, such as agents of or counsel to the Partnership and promoters and future officers of the Corporation. On various occasions, members of the Partnership were either present while threats were made or were aware of such actions. Thus, at a meeting of the limited partners, general partners and subordinated lenders Persky circulated a copy of a complaint which falsely accused Gross of churning the Buckleys' account. See note 3, supra. The Partnership had cleared all of the Buckley transactions and, as Judge Owen found, had never raised any question as to their propriety; indeed, the director of compliance for the Partnership testified that after investigation he concluded that the churning claim was without merit and that he so informed Robert Stern, who agreed with him. The record indicates that members of the Partnership either knew or had reason to know that the Buckleys had never dealt with Gross, yet even after this error was pointed out, no effort was made to correct the false allegation. In this regard, Judge Owen found that Persky, who at this time was acting as counsel for the Partnership, "not only did not care about the facts, he obviously did not *want* to know about them." The record also shows that as early as September 3, 1970, Kayne had stated in the presence of Frank and Richard Stern (general partners) that he intended to get a withdrawal of

Gross' resignation "nicely or otherwise"; at this time, Kayne, Persky and the Sterns drew up a list of "grievances" and "threats" to be used in negotiations with Gross. Similarly, Ned Frank, another general partner, drew up a list of instances of alleged malfeasance by Gross. Gross was threatened with claims of malfeasance and six claims from the Frank list were asserted as counterclaims in this action; no proof was offered on four of these claims and the other two were dismissed by Judge Owen. See note 16, supra.

Although the use of threats and the assertion of these questionable claims against Gross may not constitute malicious prosecution, coercion or abuse of process, we find that they were inconsistent with the high standards of loyalty and fair dealing demanded of fiduciaries. Cf. *A. S. Rampell, Inc.* v. *Hyster Co., supra,* 3 N.Y. 2d at 377; *Duane Jones Co., Inc.* v. *Burke,* 306 N.Y. 172, 187-89 (1954). We find no merit to the argument that Gross cannot complain of this treatment because he was attempting to use Bleich and Donoghue in order to gain special advantage. Gross was under no obligation to go along with a transfer he felt was being conducted in bad faith. It is understandable that he would seek to protect his sister and his secretary (both of whom followed him into the Newburger investment) from what he perceived as a plot to grasp the Partnership assets; indeed, Gross' apprehension was borne out by the findings of the district court. Further, partners are not relieved of fiduciary duties by strained relations between them. Crane and Bromberg, supra, §68 at 394.

The record indicates that as part of the February 11 transfer, the Corporation agreed that it would not seek to recover approximately twenty-five per cent of the outstand-

ing capital arrears of certain general partners, which Judge Owen found amounted to one-half million dollars in debt forgiveness. Andrew Newburger deposed that the debt forgiveness was bargained for in negotiations with the promoters and that the general partners with deficit positions agreed that they "should get as much forgiveness as [they] could." Judge Owen found that the debt forgiveness, which was undertaken by several general partners and acquiesced in by the rest (Gross specifically objected to the forgiveness during negotiations, however), was the *quid pro quo* for consent to the transfer. We find that it was also a form of self-dealing in violation of the fiduciary obligations owed to Gross, Bleich and Donoghue. See, e.g., *Meinhard* v. *Salmon, supra,* 249 N.Y. at 468; *Executive Hotel Associates* v. *Elm Hotel Corporation,* supra; *In re Kohn's Estate,* 26 Misc. 2d 659, 663 (Sur. Ct. N.Y. County 1952), aff'd, 282 App. Div. 1045 (1st Dept. 1953).

In sum, although there are no New York cases precisely on point, we conclude that the partners in negotiating and conducting the transfer breached their fiduciary obligations to Gross and that the promoters and Persky, acting on behalf of the Partnership and the Corporation, induced and participated in this breach of duty; accordingly, we affirm Judge Owen's findings of liability on defendants' first, second and fourth counterclaims.

We also reject Finley, Kumble's argument that it cannot be held liable for the acts of the Partnership and the Corporation. Under New York law an attorney generally cannot be held liable to third parties for actions taken in furtherance of his role as counsel unless it is shown that he "did something either tortious in character or beyond

the scope of his honorable employment." *Dallas* v. *Fassnacht,* 42 N.Y.S.2d 415, 418 (Sup. Ct. N.Y. County 1943). Thus, while an attorney is privileged to give honest advice, even if erroneous, and generally is not responsible for the motives of his clients, admission to the bar does not create a license to act maliciously, fraudulently, or knowingly to tread upon the legal rights of others. See *Steinberg* v. *Guild,* 22 App. Div. 2d 775, 776 (1st Dept. 1964), aff'd, 16 N.Y.2d 791 (1965); *D. & C. Textile Corp.* v. *Rudin,* 41 Misc. 2d 916, 918-19 (Sup. Ct. N.Y. County 1964); *Kasen* v. *Morrell,* 18 Misc. 2d 158, 162 (Sup. Ct. Kings County 1959). The issue here is simply whether Judge Owen was warranted in finding that Persky had violated this standard.

Judge Owen found that "[w]ithout question, Persky was at the heart of this entire matter, guiding the entire plan, carrying threats to the dissidents and knowingly counseling, advising and instituting baseless and fraudulent lawsuits to achieve the [promoters'] goal." Judge Owen's findings indicate that, *inter alia,* Persky was responsible for: (1) manipulating the settlement and assertion of the Buckley claim in bad faith; (2) threatening the defendants with the Buckley claim and other claims in bad faith; (3) naming Gross in the complaint as the customer's man with whom the Buckleys dealt in disregard of the truth, thereby needlessly vilifying Gross; (4) issuing a false opinion letter as "special counsel" to the Partnership, thereby furthering the transfer in violation of the rights of Bleich and Donoghue; and, (5) inducing and participating in the partners' breach of fiduciary obligation to Gross, Bleich and Donoghue. We find that the record supports the conclusion that Persky went "beyond the

scope of his honorable employment'' and the district court's finding of liability.

Damages. Finally, we turn to the subject of damages. In addition to awarding defendants what it found to be their capital interests, the court awarded Gross $50,000 in punitive damages. This was error.

In *Koufakis* v. *Carvel,* 425 F.2d 892 (2d Cir. 1970), we found that under New York law an award of punitive damages would not be proper where the wrong complained of was not " 'aimed at the public generally,' " id. at 908, quoting *Walker* v. *Sheldon,* 10 N.Y.2d 401, 405 (1961), and where the possibility of punitive damages was not necessary to induce suit to right a wrong that would otherwise go unpunished. See *Big Seven Music Corp. and Adam VII, Ltd.* v. *Lennon,* No. 76-7454, slip op. 2847, 2865 (2d Cir. April 13, 1977); *Garrity* v. *Lyle Stuart, Inc.,* 40 N.Y. 2d 354, 358 (1976). Judge Owen did not find either of these factors present nor can we on this record. See *Vinlis Construction Co., Inc.* v. *Roreck,* 27 N.Y.2d 687, 689 (1970). We can perceive no other basis for upholding this part of the judgment and, accordingly, the award of punitive damages must be reversed.

As the district court recognized, the sum of money to which the defendants were entitled was dependent upon what an accounting would show to be the capital interests of Gross, Bleich and Donoghue as of February 11, 1971. However, rather than ordering an accounting, the district court simply accepted the testimony of defendants' expert, Irving Lauterbach. Essentially, Lauterbach attacked the financial statement and schedule of partners' capital accounts prepared by Peat, Marwick, Mitchell & Co. on the

ground that it inflated the Partnership's 1970 operating losses, thereby decreasing the amount of assets available for distribution. The district court apparently accepted each of Lauterbach's objections to specific losses attributed by Peat, Marwick to the 1970 financial year and adopted Lauterbach's calculation of the defendants' interests with these items removed from the Partnership's balance sheet.

The Corporation and the additional defendants contend that Lauterbach's testimony was inherently inconsistent and in conflict with Judge Owen's findings; further, some of the additional defendants renew their contention that a proper accounting would have shown that the defendants had little or no capital interest in the Partnership. Although we note that at least in one significant instance Judge Owen's findings are inconsistent with Lauterbach's calculations,[26] we find it impossible to evaluate the Corporation and additional defendants' claims without more specific findings from the district court. It was incumbent upon the district court to resolve this dispute, which involves interpretation of the partnership agreement and a determination of the propriety of a number of additions to the 1970 operating losses, by making specific findings capable of review in this court. See Fed. R. Civ. P. 52(a); *Rapisardi* v. *United Fruit Co.*, 441 F.2d 1308, 1312-13 (2d Cir. 1971); *Fuchstadt* v. *United States*, 434 F.2d 367, 369-70 (2d Cir. 1970). Further, we can find no support in the

26. In determining the capital interests of Gross, Bleich and Donoghue, Judge Owen specifically relied on the fact that the Partnership's "financial picture" would have been strengthened had the $500,000 in debt forgiveness been collected; however, according to Lauterbach's calculations, which were relied on by Judge Owen, after certain adjustments were made to decrease the 1970 operating losses, there would have been little or no capital arrears to collect.

record for the district court's conclusion that the transfer destroyed the opportunity for an accounting. There is no evidence that any of the books or records of the Partnership necessary for an accounting were not available. Although we recognize the difficult position of the district court, which decided this case without the benefit of a transcript, we think the proper procedure here would have been for Judge Owen to make findings, in the nature of an accounting, indicating the assets and liabilities of the Partnership, the capital interest of each defendant, and how these figures were arrived at; accordingly, we remand for this purpose. We leave it to the discretion of the district court on remand as to whether this determination can be made on the present record or whether further proceedings will be advisable.[27]

C. *The Antitrust (Ninth) Counterclaim*

In January 1971, Rafkind & Co., which was a competitor of the Partnership in the brokerage business in New York City, asked Gross to be a trader for the firm's own account. In accordance with NYSE Rule 345.18, which requires a thorough inquiry into the previous record and reputation of any prospective employee, Rafkind & Co. wrote to the Partnership requesting clearance to employ Gross as a "registered representative." The Partnership responded

27. In calculating Gross' share of the Partnership assets, Lauterbach did not include as part of the Partnership assets the value of the warrants claimed by Gross in his third counterclaim. Since we reverse the judgment for Gross on the third counterclaim, we would have to remand in any event for a determination of whether the value of the warrants should be included in determining defendants' capital interests in the Partnership and what effect this would have on their recovery.

by threatening to enforce the covenant in the partnership articles which barred Gross from working as a trader at another firm before January 1972. Rafkind & Co. then withdrew its offer to Gross. On these facts, the district court found no antitrust violation. We agree.

In affirming the district court, we need not pass upon the general applicability of the federal antitrust laws to postemployment restraints. Although such issues have not often been raised in the federal courts, employee agreements not to compete are proper subjects for scrutiny under section 1 of the Sherman Act. When a company interferes with free competition for one of its former employee's services, the market's ability to achieve the most economically efficient allocation of labor is impaired. See Blake, *Employee Agreements Not To Compete,* 73 Harv. L. Rev. 625, 627 (1960). Moreover, employee-noncompetition clauses can tie up industry expertise and experience and thereby forestall new entry.

In certain cases, postemployment restraints do serve legitimate business purposes: they prevent a departing employee from expropriating his employer's secrets and clientele. See Blake, supra at 651-74. Consequently, we have held that a per se ban on all such restrictive covenants would not be warranted. *Bradford* v. *New York Times Co.,* 501 F.2d 51, 60 (2d Cir. 1974). In *Bradford* we also expressed some concern over whether the federal antitrust laws should be brought to bear on employer-employee controversies which individually have only a small impact on commerce and which have traditionally been handled in state courts. See also *Capital Temporaries, Inc. of Hart-*

ford v. *Olsten Corp.*, 506 F.2d 658, 666 (2d Cir. 1974). On the other hand, it has been argued that involvement of the federal courts is needed because widespread use of overbroad post-employment restrictions is causing serious anticompetitive harm to the national economy. See Goldschmid, *Antitrust's Neglected Stepchild: A Proposal for Dealing with Restrictive Covenants under Federal Law*, 73 Colum. L. Rev. 1193, 1206-07 (1973).

If section 1 of the Sherman Act were to be applied, two lines of inquiry seem relevant. First, there is the question of facial overbreadth: Will the restrictive covenant operate in circumstances where no valid business interest of the ex-employer is at stake? Restraints on postemployment competition that serve no legitimate purpose at the time they are adopted would be per se invalid. See generally *Northern Pacific Ry. Co.* v. *United States*, 356 U.S. 1, 5 (1958). Second, even if the clause is not overbroad per se, it might still be scrutinized for unreasonableness: Are the restrictions so burdensome that their anticompetitive purposes and effects outweigh their justifications? Restraints that fail this balancing test might be struck down under a rule of reason. See generally *Golden* v. *Kentile Floors, Inc.*, 512 F.2d 838, 844 (5th Cir. 1975); *United States* v. *Addyston Pipe & Steel Co.*, 85 F. 271, 281 (6th Cir. 1898), modified & aff'd, 175 U.S. 211 (1899); *Lektro-Vend Corp.* v. *Vendo Co.*, 403 F. Supp. 527, 532-33 (N.D. Ill. 1975), aff'd, 545 F.2d 1050 (7th Cir.), cert. granted, 429 U.S. 815 (1976) (No. 76-156).

We find no support in the record for Gross' claim on either of these possible theories. A brokerage firm has a

legitimate interest in curtailing a former partner's freedom to handle customer accounts at competing firms in order to prevent him from taking their customers with him. Gross contends the noncompetition clause in this case was overbroad because it also prohibited him from serving simply as a trader for another firm. However, the record does not indicate that anyone at the Partnership was informed that Gross would not be handling customer accounts at Rafkind & Co. Indeed, in its initial letter to the Partnership, Rafkind & Co. announced that Gross was to be employed as a "registered representative," which, as defined in NYSE Rule 10, means a broker who trades for customers' accounts and not solely for the firm account. Thus, Gross has not proved that the Partnership knowingly enforced the arguably overbroad portion of the noncompetition clause. Nor did Gross show anticompetitive impact, industry practice, etc., such as might conceivably warrant a finding that the scope of the restriction enforced was unreasonable. Since Gross failed to prove the Partnership guilty of enforcing a restraint that was overbroad per se or otherwise unreasonable, he failed to make out a case under any possible interpretation of the Sherman Act.

Gross also contends the district court erred in dismissing for lack of jurisdiction, prior to trial, his claim that the restrictive covenant violated state law. However, since we affirm the dismissal of Gross' federal antitrust claim, no principles of judicial economy, convenience, or fairness would now be served by a remand for further proceedings on the related state law issues. Regardless whether pendent jurisdiction once existed over the state law claim,

there is no longer any reason for that claim to be adjudicated in federal court. At this point, the claim can be dealt with more appropriately by a state court. See *United Mine Workers* v. *Gibbs*, supra, 383 U.S. at 726-27 (1966); note 20, supra.

In summary, we affirm the dismissal of the Corporation's churning claim, the six counterclaims against Gross, and defendant's fifth, sixth, seventh, eighth and ninth counterclaims. We also affirm the district court's finding of liability on defendants' first, second and fourth counterclaims but reverse the award of punitive damages and remand for recomputation of damages. We reverse the judgment on defendant's third counterclaim and remand with instructions to dismiss this claim.

APPENDIX B

Post-Trial Opinion of the United States District Court for the Southern District of New York

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

71 Civ. 685

NEWBURGER, LOEB & CO., INC., as Assignee of Claims of David Buckley and Mary Buckley,
Plaintiff,

against

CHARLES GROSS, MABEL BLEICH, JEANNE DONOGHUE, and GROSS & CO.,
Defendants,

NEWBURGER, LOEB & CO., a New York Limited Partnership, ANDREW M. NEWBURGER, ROBERT L. NEWBURGER, LEO STERN, ROBERT L. STERN, RICHARD D. STERN, JOHN F. SETTEL, HAROLD J. RICHARDS, SANFORD ROGGENBURG, ADOLPHUS ROGGENBURG, NED D. FRANK, ALEX AIXALA, FRED KAYNE, ROBERT MUH, PAUL RISHER, CHARLES SLOANE, ROBERT S. PERSKY, FINLEY, KUMBLE, UNDERBERG, PERSKY & ROTH, a Partnership, and LAWRENCE J. BERKOWITZ,
Additional Defendants on Counterclaims.

OWEN, District Judge

This action was tried over a period of seven weeks. It began as a "three weeks" jury trial, but by stipulation ended as a bench trial as the summer slipped away and the jury became restive. While the issues are varied, they center upon the activities of Charles Gross, a sometime part-

ner in Newburger, Loeb & Co., a brokerage partnership (hereinafter "the Partnership") and his opposition to the transfer of its assets to a proposed successor corporation, Newburger, Loeb & Co., Inc. (hereinafter "the Corporation") in 1971.

The action is in this Court because the Corporation first alleged a "churning" claim[1] against Gross & Co. and partners Charles Gross,[2] Mabel Bleich, and Gross' sister, Jeanne Donoghue.[3] This action was brought by the Corporation as the assignee of David Buckley and Mary Buckley, who had had accounts with Gross & Co. prior to its becoming inactive and Charles Gross becoming a partner of the Newburger partnership.

Thereafter, Gross, Bleich and Donoghue counterclaimed, alleging non-federal causes of action against the Partnership and others brought in as additional defendants on the said counterclaims. These additional defendants are certain partners of the Partnership,[4] the promotors and thereafter principal officers of the new Corporation (hereinafter sometimes called the "new team"),[5] a large inves-

1. *See Hecht* v. *Harris, Upham & Co.*, 430 F.2d 1202 (9th Cir. 1970).

2. The complaint alleges Gross to be the partner with whom Buckley dealt. It is the undisputed fact that Buckley dealt only with Charles Jordan, another partner at Gross & Co. While this pleader's error has certain evidentiary significance discussed hereafter, I deal with the claims herein as if Jordan had been alleged instead.

3. Jean Donoghue was in fact added to the first pleading by a subsequent amendment.

4. Andrew M. Newburger, Robert L. Newburger, Leo Stern, Robert L. Stern, Richard D. Stern, John F. Settel, Harold J. Richards, Sanford Roggenburg, Adolphus Roggenburg, and Ned D. Frank.

5. Fred Kayne, Robert Muh, Paul Risher, Charles Sloane and Lawrence J. Berkowitz.

tor in the Corporation, Alex Aixala,[6] the law firm today known as Finley, Kumble, Heine, Underberg & Grutman,[7] and Robert Persky, its then partner. The essential allegations of the Gross, Bleich and Donoghue claims are that the partners wrongfully transferred the assets of the Partnership to the Corporation without the consent of limited partners Bleich and Donoghue, and that the partners, the said promotors, and Finley, Kumble and its partner, Robert Persky, entered into a conspiracy, which conspiracy was intended to and did in fact injure Gross, Bleich and Donoghue in their property in connection with the said transfer of assets and because of their opposition to it.

Finally, on the third and last pleading round, the Partnership and the defendants on counterclaims asserted nonfederal "counterclaims" against Gross, consisting in the main of allegations of malfeasance while the managing partner of the Partnership.

While the details are extensive,[8] the overall thrust of the case is simple.

Taking first the allegations of the complaint, plaintiff Corporation alleges that Gross & Co. and partners Charles Gross and Mabel Bleich and Jeanne Donoghue wrongfully induced and failed to supervise certain extensive transactions in the brokerage accounts of one David Buckley and his wife Mary from April 1962 until August 1966. It is

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6. The case against Aixala was dismissed at the close of defendants' proof by the Court.

7. Then known as Finley, Kumble, Underberg, Persky & Roth.

8. It should be noted that no party ordered a transcript herein. The Court in arriving at its conclusions relies on its own notes and those of a courtroom observer employed by certain additional defendants taken over the seven weeks of trial.

alleged that the accounts were excessively traded primarily for the purpose of generating commissions to Gross & Co.,[9] a violation of Section 10(b) of the Securities Exchange Act and Regulation 10(b) promulgated thereunder, as well as a violation of the common law duties owed by Gross & Co. and its partners to the Buckleys.

The accounts were margin accounts with the Partnership through which Gross & Co. cleared. One Charles Jordan was the Gross & Co. customer's man with whom Buckley dealt. On paper the accounts were highly profitable until trading was suspended for a lengthy period on a highly speculative issue in which Buckley had heavily invested. This put the accounts $332,000 in the red with the Partnership. The Partnership, after an extensive delay, endeavored to collect its loss, but was met with a threat of bankruptcy by Buckley and his wife if the collection efforts were pressed together with a proposal of a $50,000 settlement[10] if the claims could be totally resolved. At some later point, over four years after the last transaction, the Partnership commenced an arbitration against the Buckleys for the $332,000 arrears and for the first time the Buckleys asserted a churning claim in the amount of $75,000 by way of counterclaim. The arbitration never took place and the case was settled for the said $50,000, in addition to which the Partnership took the assignment of any claim the Buckleys might have had against Gross & Co.

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9. Gross & Co. cleared all its transactions through Newburger, Loeb & Co. The latter, having an overview of all these trades, never raised any question as to their propriety.

10. The money was apparently to come from Buckley's father, a successful executive.

Appendix B

The Partnership thereafter appears to have assigned that claim to the successor Corporation, which filed the churning claim in this Court.

Having carefully considered the evidence, it is clear that while there were a great number of transactions over a three year period, they were motivated by the desire of David Buckley, the son of a very successful father, to make his own name and fortune in the market by profitable speculation. He was a thoroughly knowledgeable young man as to the market. He read securities publications to keep himself informed. The accounts were non-discretionary, and Buckley had to and did authorize every transaction. He proposed some of the transactions and the vast majority of the transactions proposed by Jordan he declined. The statistical "chart" of the trades which Buckley prepared, and which was somewhat misleading and subject to question, I do not find persuasive of a "churning" claim when viewed, among other things, against Buckley's control of the accounts, his other and earlier accounts with other brokers, his friends in the field with whom he consulted, his studying of financial publications and his desire to make it on his own, albeit with his father's money. I therefore have no question that the churning claim has not been proved and find for the defendants, dismissing the plaintiff's 1st, 2nd and 4th causes of action. *Hecht* v. *Harris, Upham & Co., supra.* The 3rd cause of action was heretofore dismissed by Judge Ward on motion. There being no violation on the part of defendants on the merits, the 5th cause of action for plaintiff's counsel fees is necessarily dismissed.

Appendix B

That brings the Court to the second round of allegations, the first, second and fourth counterclaims alleged in the amended answer by Gross, Bleich and Donoghue, which are at the heart of this proceeding.[11] The first counterclaim alleges as to plaintiff Partnership, the Corporation and all the defendants named as additional defendants on counterclaims the following: that the transfer of the Newburger partnership assets to the Newburger Corporation without the consent of Mabel Bleich or Jeanne Donoghue, limited partners in good standing, was in violation of §98 of the Partnership Law of the State of New York and that Gross, Bleich and Donoghue are entitled to damages by reason thereof.

Section 98 of the Partnership Law provides as follows:

> "(1) A general partner shall have all the rights and powers and be subject to all the restrictions and liabilities of a partner in a partnership without limited partners, except that without the written consent or ratification of the specific act by all the limited partners, a general partner or all of the general partners have no authority to
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>
> "(b) Do any act which would make it impossible to carry on the ordinary business of the partnership."

The factual background is as follows. In July 1969, Charles Gross, who was a partner in Gross & Co., with

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11. Defendants alleged eight counterclaims. Judge Ward held only the first, second and fourth to be "compulsory counterclaims," the remainder being maintainable only to the extent they constituted a set-off. Since I find for the defendants on the plaintiff's causes of action, *supra*, I need not and do not consider the counterclaims constituting merely set-offs.

space on the Newburger Loeb floor and clearing through it, was approached with the idea of becoming a partner of the Partnership and agreed to do so, terminating the operation of Gross & Co. He became a general partner with an initial investment in excess of $400,000 and his sister, Mrs. Donoghue, and Mabel Bleich, former partners in Gross & Co., became limited partners of Newburger Loeb to the extent of $75,000 apiece.

Months passed and Gross was asked to and did become the managing partner of the Partnership. Out of a feeling of confidence in the operation, he thereupon invested another $400,000. As with many Wall Street brokerage firms, however, the Partnership was not prepared for the record keeping problems caused by the greatly increased volume of transactions in the late 1960's, causing the "back office crunch," which damaged or destroyed many firms failing to meet the capital requirements with the New York Stock Exchange. Whether Charles Gross was quite up to the management of a firm of this size with these problems, I need not decide. In any event, as a result of accumulated problems and pressures and the "back office crunch," after approximately one year under Gross' aegis, the firm came to a point in the summer of 1970 when it was realized that there should be new and more vigorous management. Fred Kayne, who was a partner and had managed the Los Angeles office, and certain younger outsiders became more and more involved in the overall operation of the firm. The pressures upon Gross thereafter caused him to resign as managing partner and, being dissatisfied with what he saw as the quality of the new managers, Gross decided to withdraw as a partner and gave notice thereof in July 1970,

becoming a "withdrawn general partner" with his capital however remaining at the risk of the firm for an additional twelve months pursuant to the partnership agreement.

During the fall of 1970, as the firm's position worsened, a power struggle commenced which eventually resulted in a fairly unified front by the often antagonistic members of the new team. The new team, consisting of Sloane, Kayne, Muh, Risher and Berkowitz, guided and counseled by Robert Persky of the firm of Finley Kumble, saw themselves in a position to take over control of the old firm, reconstituting it as a corporation with the possibility of substantial rewards for a small investment.[12] To achieve this end, various problems had to be solved by the new team. Among these was the obtaining of the consent of the general partners of the Partnership to a transfer of the assets. This was accomplished in major measure by a "forgiveness" of some $500,000 of partners' capital arrears which had not been paid in.[13] Another major problem, that of new capital, was resolved when Persky put Alex Aixala into the picture with a loan of $1,000,000 secured by his wife's Biccardi Rum stock in a virtually risk free situation.[14] Another "problem" was to get back into the treasury of the Partnership for eventual transfer to the Corporation certain warrants and rights in the Partnership name, title to which had been lawfully transferred to the partners as an "in

12. They were correct in this appraisal. Kayne sold his $10,000 investment a year later for $400,000.

13. Gross was not only fully paid up, but had an additional $400,000 in the firm; *see* p. 8, *supra.*

14. Aixala got his entire $1,000,000 out within a relatively short period of time.

kind'' distribution of income. This was accomplished by the simple act of seizure of the certificates themselves, and their sequestration in the hands of he new team.[15] Another problem was to minimize any outflow of cash to dissidents, principally Gross and limited partners Jeanne Donoghue and Mabel Bleich.

The new team was aware that limited partners Bleich and Donoghue were owed $75,000 apiece absent any setoffs that could be asserted against them. At one point, in working on their various problems, the new team determined to pay Mrs. Donoghue her $75,000 to get her out of the picture,[16] while expecting Miss Bleich to convert her $75,000 Partnership interest to one of stock ownership in the new Corporation.

The ''problem'' of Charles Gross was a more difficult one. Gross took the position that as a withdrawn general partner, there could be no transfer of the Partnership assets to a corporation without his consent, or, alternatively, return of his capital as it might be established at the time. Conversely, while the new team was bringing in new capital, it obviously did not want to simultaneously pay out any substantial monies to Gross. The way to deal with Gross, the new team determined, was to threaten him with prospective or actual litigation which would either coerce him into going along with their plans or, if that failed, would give them a basis for refusing to pay him. Sloane and

15. Kayne's explanation of his letter directing this seizure was thoroughly unconvincing.

16. Apparently, the new team, recognizing that Mrs. Donoghue lived in Australia, felt she was too far away to deal with effectively, and it was therefore easier to buy her out.

Kayne threatened to institute a lawsuit against him in California.[17] Persky, in an unusual move, settled the Partnership's $332,000 suit against Buckley (which included Buckley's $75,000 churning counterclaim) for $50,000 and took an assignment of the said churning claim. He then prepared a complaint alleging $250,000 damages[18] for churning in federal court against Charles Gross, erroneously alleging him to have been the customer's man with whom the Buckleys dealt.[19]

The new team also obtained from one Ned Frank, a Partnership partner, now deceased, and highly antagonistic to Gross, a list of some twenty alleged instances of malfeasance by Gross while he was managing partner. Gross

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17. This action involved an alleged fraudulent inducement to Kayne to become a partner in Newburger Loeb with an investment of $50,000. The manner in which the damages became $3,000,000 is not clear and I conclude it was an *in terrorem* figure. The action was dismissed in Federal Court and sent to arbitration before the New York Stock Exchange. Before the Exchange, Gross was completely vindicated.

18. Finley Kumble's triple inflation of the Buckley claim when asserted against Gross was "justified" by a then associate of the firm on the trial by a barely arguable theory coupled with the observation that the defendant has the burden of proving the plaintiff wrong.

19. When this clear error was later pointed out to the Finley Kumble (Persky's) firm, it never bothered to execute a stipulation to correct it nor add the actual customer's man, Jordan, as a party to the action. The Finley Kumble partner involved "just could not get around to it." One can conclude the action was serving its purpose by its mere existence. I regard it as also significant on the question of *bona fides* that Persky, who represented the Partnership, never bothered to speak to Gross, still a partner, before bringing a fraud action against him on the sole basis of allegations in an arbitration by a customer. Persky not only did not care about the facts, he obviously did not *want* to know about them. This is a clear violation of Rule 11, Fed.R.Civ.P. requiring "good ground for the assertion of a pleading."

was threatened with suit as to these. Six were in fact later asserted against him in this litigation.[20]

Further, Gross having withdrawn as a general partner, and having no source of income, was looking for new employment and had an opportunity to become a trader with the firm of Rafkind & Co. Trading was an area in which Gross was known by all to be very experienced. While there was a non-competition clause which the new team had the legal right to assert, there was no economic justification for so doing other than using this as a further club against Gross. This is what the new team did. It was suggested to Gross that if he went along with them, they would free him to engage in trading activities with Rafkind. He did not and they did not.

The direct and circumstantial proof is quite clear that all the foregoing was participated in by all the members of the new team[21] acting out of the single motive to force Gross into accepting the new team's dictates. Gross, however, did not succumb to these threats and promises. He early formed a dislike for the new team and wanted no association with them. Thus, when the new team eventually proposed to transfer the Partnership assets to the Corporation, Gross would have none of it, and insisted that he be paid his share of the capital and eventually Bleich and Donoghue similarly insisted that they be paid their

20. No proof was offered on four. The remaining two were without merit, *see* pp. 20-22, *infra*.

21. The proof as to Berkowitz' participation was substantially weaker than as to the others. While he participated in the Rafkind matter and, to some minor degree in the Buckley case, he does not appear to have participated in any threats to Gross with others of the new team. I therefore dismiss as to Berkowitz.

$75,000 limited partnership contribution, else there would be no consent by any of them to the proposed transfer. In this regard, they were relying upon Section 98 of the Partnership Law, *see* p. 8, *supra*. The new team, aware of the impact of Section 98, announced at one point that it would have to abandon the transfer if all consents could not be obtained (*see* Persky's letter n.23, *infra*), and took the position that they were unable to make the appropriate payments. Gross, Bleich and Donoghue, rejecting this self-serving gloomy statement of the financial picture, took the position that were the Partnership to be liquidated, even up to the date of the transfer to the Corporation, there would be assets available on such a liquidation to pay them and that they insisted upon their right to a dissolution and an accounting, if necessary, under the Partnership Law.

Events were complicated by the fact that in early February 1971, the Partnership was in such violation of the Stock Exchange's requirement of minimum capital that the Exchange threatened to close the Partnership down on February 12, 1971 if it had not raised sufficient additional capital by February 11. Given this, the new team increased the pressures upon Gross to go along with the deal. Persky had typed up and exhibited the proposed Buckley complaint to Gross. Kayne and Sloane instituted the $3,000,000 action against him in California, and Persky threatened him with the Frank "list" of malfeasances—all to no avail. The new team nevertheless went forward. It had obtained the consents of the other partners to the transfer by forgiveness of substantial capital arrears. It had Aixala available with his $1,000,000 and was ready with small personal in-

vestments and the willingness to capitalize on them. A closing was arranged.

An essential document to be presented at this closing was a letter by counsel to the Partnership,[22] the seller, that the transaction was a lawful one under New York law. Two days before the closing, seller's counsel advised an associate of the Finley Kumble firm that absent Bleich and Donoghue's signatures as limited partners, it could not give the necessary opinion letter in the light of Section 98. It is reasonable to assume that this advice was passed on to Persky who prepared himself to deal with the situation by having some alleged "research" done. At the time of closing, he professed astonishment when the letter was not forthcoming and although he was attorney for the buyer (the new Corporation), he immediately announced himself willing" as "special counsel" to give such a letter on behalf of the seller, contradicting his earlier view.[23] The seller's partners and their lawyer present at the closing went along with this proposal, apparently as a matter of business

22. The firm of Rosenman, Colin, Kay, Petschek, Freund & Emil.

23. Persky earlier had unequivocally expressed in writing his own view that the signatures of Bleich and Donoghue were essential to the transfer. In his letter to all counsel of February 2, 1971, he stated:

> "Mabel Bleich has informed us by letter dated February 1, 1971, from her attorneys, Golenbock and Barell, that she has withdrawn from the reorganization of Newburger, Loeb & Co.
>
> * * * *
>
> "Unless we are advised in writing that Miss Bleich will consent to the reorganization on or before 4:00 P.M. on Thursday, February 4, 1971, our plans to close on February 11, 1971 will be cancelled . . . ."

judgment,[24] and the closing went through. Gross, Bleich and Donoghue, who were not present, were never consulted and their interests were disregarded. The spurious as well as "thrice inflated" Buckley claim was asserted against all three and the baseless Kayne action was pressed against Gross as devices to justify the Corporation's refusal to pay any of them any sums of money. This action, with its various ramifications, including the belated assertion as counterclaims of six of the meritless Frank claims, *see* pp. 20-22 *infra,* followed.

I find there was a deliberate plan by Messrs. Sloane, Kayne, Muh, Risher and Persky to injure Gross, Bleich and Donoghue as part of their steps to take over the new operation on a shoestring and directly enrich themselves; Persky, by getting a new client for himself and his firm. Various threats were made which are significant. Sloane threatened Gross on the telephone, Kayne threatened him at a luncheon meeting; Persky threatened him at a meeting with counsel. Present at that meeting were Risher and Muh. Indeed, the events in the ten minutes following that latter meeting with Gross are highly illuminative. Persky, Risher and Muh immediately went to the lobby. There, Persky called Kayne in California, reporting that his

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24. It was argued before me that this "going along" was some evidence of the opinion of independent counsel at the closing that the closing *could* proceed absent the required consents under Section 98. I do not find this to be the case. I find that the partners consenting did so as a matter of business judgment having been forgiven substantial capital arrears and hoping that the transfer to the Corporation would save their deeply threatened interests in the continuing Newburger operation. I conclude that they were prepared to accept the letter Persky proposed and delivered and the risks of illegality which went with it as a deliberate business choice.

threats had no success. Kayne immediately called Sloane and Sloane immediately called Gross angrily, saying: "I've lost money here. If you kill the deal, you'll be sued for a long time." It is further significant that Persky, Kayne and Sloane all at various times threatened Gross with suit. Risher spoke to Mabel Bleich telling her if she did not go along she and Gross would be sorry, and threatened the Buckley claim. He made her cry.

I find that all of them were actively participating, knowing what each was doing and hoping to reap substantial benefits from this joint conduct. I find that the partners of the Partnership, although motivated by their desires to save their investments in the operation, lent themselves to the goals of this conspiracy by affirmatively permitting the Partnership to transfer its assets to the Corporation in violation of Section 98 of the Partnership Law and in violation of their fiducairy duties to Gross, Bleich and Donoghue as other partners, and by their knowing acquiescence in the use by the new team of the various baseless litigation threats against Gross.

Finding as I do that there was a conspiracy by the defendant members of the Partnership[25] and the new team (except Berkowitz) as officers of the Corporation[26] and Persky to injure Gross, Bleich and Donoghue in their interests in the Partnership, I find that each is individually and collectively liable, as is Finley Kumble, Persky's firm, to Gross, Bleich and Donoghue for the damages sustained by their conduct.

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25. Andrew M. Newburger, Robert L. Newburger, Leo Stern, Robert L. Stern, Richard D. Stern, John F. Settel, Harold J. Richard, Sanford Roggenburg, Adolphus Roggenburg and Ned D. Frank.

26. Fred Kayne, Robert Muh, Paul Risher, Charles Sloane.

Appendix B

Newburger, Loeb Corp., in its reply, asserted six "counterclaims" against Gross. These were Paragraphs 55 through 93 of the reply. Four of them (the second, fourth, fifth and sixth) were abandoned at the trial, plaintiff offering no proof thereof. Of the two remaining, the first alleges that Gross had a trading account for which he secretly and wrongfully took partnership funds and secretly traded to the damage of the Partnership in the sum of $148,000. The entire support for these allegations comes from the testimony of one Edmund Rubin who, it is clear, was a disgruntled former partner of Gross'. Rubin's testimony was sketchy and weak in any event. I find it to be false in all material aspects for it was completely contradicted, not only by other partners (they, too, it should be noted, having no love of Gross), but also by contemporaneous partnership records. I find Gross' trading, as alleged, was authorized by and known to the executive committee. To the extent that it was kept confidential within the firm, it was established that the purpose of this was to prevent gossip on Wall Street as to what Gross, well known as a skillful trader, was buying for the Newburger Loeb account which would have affected the market in those stocks. I dismiss the plaintiff's first counterclaim.

The third counterclaim charges that during the "back office crunch" on Wall Street in 1970, Gross, as managing partner, knowingly caused the Partnership to submit false answers to the New York Stock Exchange in response to certain Special Operating Questionnaires. Certain erroneous answers were indeed filed over the signature of Gross and another partner and the Partnership was fined

$50,000 therefor. However, I find that Gross—not a "back office partner"—had no personal awareness of the errors in the answers occasioning the fine. Absent this, there can be no personal responsibility to the Partnership. I dismiss the third and remaining counterclaim, thus disposing of all the "counterclaims" raised by plaintiff.

Turning to the question of damages, the various groups of participants must be treated separately. This is because there are basically three areas of damage with different participants in each. Those areas are (1) the conversion of the capital of Gross, Bleich and Donoghue, (2) the conversion of Gross' "in kind" securities, and (3) punitive damages.

There is absolutely no question that all other things being equal, Miss Bleich and Mrs. Donoghue were entitled to the return of their investment of $75,000 each.[27] The amount of capital owing to Gross as of February 11, 1971, however, depends upon what an accounting would have then shown or today shows with a fair degree of certainty was owing to him on that date. Plaintiff and additional defendants on counterclaims argue that an accounting would have shown that no monies would have been available to pay Gross, Bleich or Donoghue any sums had there been an accounting on February 11, 1971. They base this on certain Peat Marwick figures in the relevant time period. I find, however, to the contrary. One Irving Lauterbach, an accountant, testified in detail as to the said Peat Marwich figures and convincingly demonstrated that those figures were wholly inaccurate by reason of write-offs

27. Certain defendants even acknowledged this in a pre-trial memorandum of law.

wrongfully attributed to the period in question. An improperly low figure was thus accomplished by members of the new team telling Peat Marwick what to put in the statement, which Peat Marwick accepted without further inquiry. Removing these items from the Corporation's balance sheet, as Lauterback demonstrated was proper, I conclude that there would have been sufficient assets in the Partnership as of February 11, 1971 to pay Bleich and Donoghue each the return of their $75,000 investment.[28] plus accrued interest, and further, that Gross' capital interest due and payable as of that date was $337,921.[29]

In arriving at the foregoing conclusion, I am fortified by the fact that the new team had forgiven certain partners over $500,000 in capital arrears, which sums or portions thereof, had they been collected, would obviously have strengthened the financial picture even further, providing monies from which to pay Gross, Bleich and Donoghue. Further, the Corporation assumed the liabilities of the Partnership and is in any event equally responsible for the said amounts, which it could have paid from the Aixala $1,000,000. Similarly, the partners of the Partnership, by wrongfully permitting the transfer of the assets to the Corporation in knowing contravention of Partnership Law

28. Additional support for this is found in the fact mentioned elsewhere that the new team was willing to pay Mrs. Donoghue her $75,000 for her consent shortly before the closing.

29. It is argued that the Partnership was "up against the wall" by reason of the New York Stock Exchange's ultimatum and that this justified a violation of the clear language of Partnership Law Section 98, *supra*, as against a dissident minority. I reject this argument. Section 98, as I view it, is designed to prevent this very type of riding roughshod over minority interests, thus guaranteeing them protection.

Section 98,[30] destroyed the opportunity for an accounting which could have revealed the amounts I find to have been owing, and damaged Gross, Bleich and Donoghue accordingly. This is especially egregious, given the large amounts of capital forgiveness by which they were "induced" to go along.

Also, similarly, by causing the transfer to take place in knowing violation of Section 98, the members of the new team are individually liable for this damage. Without question, Persky was at the heart of this entire matter, guiding the entire plan, carrying threats to the dissidents and knowingly counseling, advising and instituting baseless and fraudulent lawsuits to achieve the new team's goal, or for specific remuneration,[31] and to obtain a lucrative client for his firm. Unquestionably, Persky's firm is responsible for his actions.[32]

The members of the new team, by conspiring to effect the transfer of the assets to their new corporation to the damage of Gross, Bleich and Donoghue are also liable individually for the conversion damages specified.

Turning to the matter of the conversion of Gross' "in kind" securities, there is no question that ownership of certain warrants to buy stock in Geon Industries, Inc. and Computer Softwear Systems, Inc. had vested in Gross as

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30. They were aware the Rosenman firm had refused to give the necessary opinion.

31. Finley Kumble records as to fees paid by anyone connected with the matter have vanished. I conclude that these were embarrassingly large.

32. Persky testified at the trial, and certain others of the firm testified also in support of his and the firm's actions, *see* p. 13, *supra*. I find the said supporting testimony distressingly unsatisfying.

an in-kind distribution of Partnership profits in August of 1970, the certificates in the firm's name remaining in the partnership safe. It is undisputed that Kayne wrote a letter to Risher, with copy to Persky, directing him to physically take possession of those certificates and put them in "the vault of one of our own banks." This purloining was accomplished and Gross was stripped of his securities.

It is well established that the measure of damages in such a case is the greater of the following: (1) the value at the date of conversion, (2) the profits received by the corporation in connection with its disposition of these securities, or (3) the highest value of these securities at any reasonable time after conversion. *In Re Salmon Weed & Co.*, 53 F.2d 335, 341 (2d Cir. 1931); *Harford* [sic] *Accident & Indemnity Co.* v. *Walston & Co., Inc.*, 22 N.Y.2d 672 (1968); *Mayer* v. *Monzo*, 221 N.Y. 442, 446 (1917); *German* v. *Snedeker, et al.*, 13 N.Y. Supp. 2d 237 (1937). It appears that the highest value of Geon in a reasonable period after the conversion (March 1972) was $42.25 a share. The exercise price of the warrant at that time was $6.875, leaving a per share profit of $35.375, for a total of Gross' shares of $58,000 damages. As to Computer Softwear, the highest price was reached in March 1973, still not an unreasonable period, and figured similarly, Gross' share of the profits attributable to him would have been $75,803. I find Kayne, Risher, Persky and his firm, Finley Kumble, responsible for the said damage due to this wilful conversion.

Next, I turn to the subject of punitive damages. The new team and Persky—not only counsel thereto, but one of

its actors and spokesmen—asserted numerous threats against Gross to coerce his acqiuescence and that of his sister and colleague. These parties knowingly commenced baseless actions against him and Bleich and Donoghue to stand off payment. Persky, among others, made it clear to Gross that if he did not go along with the new team, he would be tied up in litigation for a long time and injured in his livelihood. Persky solicited claims from partner Ned Frank to use as threats against Gross.[33] All were baseless, *see* pp. 20-22 *supra*. These claims and attendant villification [sic] were solely used as bargaining tools against Gross, which he had the personal courage, fortified by the courage and determination of his counsel, to oppose over long years.

Further, there was the deliberate purloining of Gross' warrants, and finally there was the knowing transfer by the new team, counseled by Persky, of Partnership assets in clear disregard of Section 98 and based upon Persky's worthless opinion letter; the various filings of baseless claims in this and other courts to justify "non-payment;"[34] and the wrongful forgiveness of over one half million dollars in partners' capital arrears, all of which required Gross, Bleich and Donoghue to obtain counsel to prepare and try a seven weeks' case to collect money obviously due after an accounting in 1971.

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33. Gross claims that the new team destroyed the Rafkind opportunity, *see* p. 11, *supra*. I cannot conclude by a clear preponderance of the evidence that this gives rise to a cause of action for damages, and I dismiss the claim. The facts embodied in the claim, however, are in my opinion additional evidence of the new team's basic unified stance of favoring or threatening Gross depending upon whether they thought he was opposing their takeover or not.

34. Not to mention the new team's efforts through the furnishing of misinformation to Peat Marwick to create a misleadingly low balance sheet.

Appendix B

The foregoing gross departure from moral behavior and utter, malicious disregard of another's rights entitles Gross, who was the prime suspect of the villification and baseless suits and who carried virtually the entire laboring car here to punitive damages against the new team (except Berkowitz), Persky and Finley Kumble in the sum of $50,000.[35]

In sum, I find (1) in favor of defendant Gross and against plaintiff and each of the additional defendants on counterclaims (except Berkowitz) on the first, second and fourth counterclaims in the sum of $337,921.00 plus interest since February 11, 1971 by reason of the wrongful conversion of his capital, and (2) in favor of defendant Gross against each of the new team (except Berkowitz) and Persky and Finley Kumble in the sum of $134,171.75 for the wrongful conversion by said parties of Gross' "in kind" securities.[36] Further, I find in favor of defendant Gross and against the new team (except Berkowitz) and Persky and Finley Kumble in the sum of $50,000 as punitive damages for their deliberately wrongful conduct herein.

I further find in favor of each of the defendants Joanne Donoghue and Mabel Bleich against plaintiff and each additional defendant on counterclaim (except Berkowitz) in

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35. *See, e.g.*, Reynolds v. Pegler, 223 F.2d 429 (2d Cir. 1955); Farowitz v. Associated Musicians, 241 F.Supp. 895 (S.D.N.Y. 1965); *see* also Mid-Continent Telephone Corp. v. Home Telephone Co., 319 F.Supp. 1176 (N.D. Mass. 1970).

36. This item of damage is arguably pleaded in Paragraph 44 of the amended answer. In any event, the issue was fully litigated and the pleadings are hereby amended to conform with that proof in accordance with a motion made by Gross' counsel at the close of the trial.

the sum of $76,868.75,[37] together with interest thereon from December 31, 1970, for the wrongful conversion of the capital contribution of each.

All remaining claims of all parties are hereby dismissed.

The foregoing constitutes the Court's findings of fact and conclusions of law and is so ordered. Submit judgment on ten days' notice.

July 7, 1976.

s/ RICHARD OWEN

United States District Judge

37. $1,868.75 interest was already owing on each of these defendants' contributions to capital as of December 31, 1970.

APPENDIX C

Pre-Trial Opinion of the United States District Court for the Southern District of New York

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

71 Civ. 685

R.J.W.

NEWBURGER, LOEB & CO., INC., as Assignee of Claims of David Buckley and Mary Buckley,
Plaintiff,

against

CHARLES GROSS, MABEL BLEICH and GROSS & CO.,
Defendants,

NEWBURGER, LOEB & CO., a New York Limited Partnership, ANDREW M. NEWBURGER, ROBERT L. NEWBURGER, LEO STERN, ROBERT L. STERN, RICHARD D. STERN, JOHN F. SETTEL, HAROLD J. RICHARDS, SANFORD ROGGENBURG, ADOLPHUS ROGGENBURG, NED D. FRANK, ALEX AIXALA, FRED KAYNE, ROBERT MUH, PAUL RISHER, CHARLES SLOANE, ROBERT S. PERSKY, FINLEY, KUMBLE, UNDERBERG, PERSKY & ROTH, a Partnership, and LAWRENCE J. BERKOWITZ,
Additional Defendants on Counterclaims.

Appearances:

FINLEY, KUMBLE, UNDERBERG, PERSKY,
ROTH & GRUTMAN, Esqs.
Attorneys for Plaintiff
HERBERT F. ROTH, of Counsel

Appendix C

GOLDEN, WIENSHIENK & MANDEL, Esqs.
Attorneys for Defendants
PHILIP MANDEL, Esq.
BERNARD ROTHMAN, Esq. of Counsel

RICHENTHAL, ABRAMS & MOSS, Esqs.
Attorneys for Defendants on Counterclaim
DAVID ABRAMS, Esq., of Counsel

HART & HUME, Esqs.
Attorneys for Defendants on Counterclaim
CHARLES ACKER, Esq., of Counsel

WARD, D. J.

There are presently before the Court a motion by defendants for summary judgment dismissing the complaint and for partial summary judgment with regard to certain counterclaims, a motion by plaintiff and additional defendants on the counterclaims to dismiss the counterclaims, a separate motion by additional counterclaim defendant Alex Aixala seeking summary judgment in his favor, and a motion by certain of the additional defendants on the counterclaims for a stay of this action pending arbitration.

Plaintiff as assignee asserts a churning claim arising from transactions in a brokerage account maintained by David Buckley with defendant Gross & Co., a partnership, from 1962 to 1966. Defendant Gross was a general partner and defendant Bleich a limited partner of Gross & Co. throughout that period. Jean Donoghue who has appeared as a defendant and counterclaimant was also a limited partner of Gross & Co. Gross subsequently became a general partner and Bleich and Donoghue limited partners of

Newburger, Loeb & Co. ("the Partnership"), which was the predecessor in interest of the plaintiff Newburger, Loeb & Co., Inc. ("the Corporation").

A controversy arising in 1970 between the defendants herein and the other members of the Partnership regarding the sale of the Partnership assets and liabilities to the Corporation has become inextricably intertwined with the comparatively simple churning claim. As the facts have been presented, the Partnership was in dire financial straits and threatened with imminent suspension from the New York Stock Exchange and dissolution. The decision of the other partners to sell the assets and liabilities of the firm to a newly-formed corporation which would bring an infusion of new capital was hotly contested by Gross, Bleich, and Donoghue. These three refused to sign the agreement consummating the sale (hereinafter referred to as the Transfer Agreement).

In addition to defending this suit on the ground that there was no churning of the Buckley account, the defendants also assert other defenses and nine counterclaims.

A. *Plaintiff's and Additional Defendants' Motion to Dismiss the Counterclaims.*

Plaintiff and all additional defendants on the counterclaims move to dismiss the First through Eighth counterclaims for lack of subject matter jurisdiction and the Ninth counterclaim for failure to state a claim upon which relief can be granted. Fed. R. Civ.P. 12(b)(1) and (6).

The First and Second counterclaims which are also raised as defenses to plaintiff's action are compulsory

counterclaims, as they are concerned with "the same transaction or occurrence" that is the subject matter of plaintiff's claim. Fed. R. Civ. P. 13(a). They are so closely linked to defenses to the plaintiff's claim that they must be considered "logically related to the claim the opposing party is suing on." C. Wright, Law of Federal Courts 346 (2d Ed. 1970). This conclusion is consistent with the general trend toward expansion of the concept of compulsory counterclaims. *See United States* v. *Heyward Robinson Company*, 430 F. 2d 1077 (2d Cir. 1970), *cert. denied*, 400 U.S. 1021 (1971). The Fourth counterclaim asserts the same allegedly wrongful acts pleaded as defenses; therefore, it, too, is a compulsory counterclaim. As to these claims no independent basis of federal jurisdiction is necessary as they are viewed as ancillary to the claim asserted in the complaint. *Id.* at 1081.

The Third, Fifth, Sixth, Seventh and Eighth counterclaims are not logically related to the plaintiff's cause of action; therefore, they are not compulsory counterclaims. Since there is no independent basis for federal jurisdiction, these counterclaims may be maintained only to the extent that they constitute a set-off; they may not be asserted as a basis for affirmative relief. *Id.* at 1080-81.

The Ninth counterclaim, asserted only by defendant Gross, alleges that the sale of the business of the Partnership and the alleged interference with an employment opportunity offered to Gross constitute a violation of the Sherman Act and the Clayton Act, 15 U.S.C. §1 *et seq.* Since there is no special pleading requirement in anti-trust actions, *Nagler* v. *Admiral Corporation*, 248 F. 2d 319 (2d

Cir. 1957), the allegation, skeletal though it may be, sufficiently states a claim to withstand a motion to dismiss.

B. *Additional Defendants' Motion for a Stay Pending Arbitration.*

Certain additional defendants on the counterclaims, former partners of Newburger, Loeb & Co., the Partnership, have moved alternatively for a stay pending arbitration. Although the Court recognizes the validity of the New York Stock Exchange arbitration rules and the provisions of the Partnership Agreement as well as the federal policy in favor of arbitration, it finds that given the combination of circumstances present in this case, retaining and continuing the litigation in this Court will best serve sound judicial administration and further the interests of justice.

A review of the record indicates that the moving counterclaim defendants waited an inordinately long time before bringing this motion. During this period opposing counsel consented to numerous extensions of time for counterclaim defendants to answer or move; and extensive discovery both formal and informal, in which the moving parties participated has taken place. At no time while this activity, clearly pointing toward a judicial determination, was taking place and not until the bringing of the instant motion did these counterclaim defendants indicate that this action should be referred to arbitration. If this action were now to proceed to arbitration, it undoubtedly would result in another delay. It, therefore, seems clear that arbitration in this case would not serve to produce the speedy settlement of this dispute which is a primary reason for resorting

to arbitration. Although these factors standing alone might not constitute a sufficient showing of prejudice to bar a stay, they are sufficient when combined with the fact that not all parties to this litigation are subject to arbitration.

Since this litigation would continue in this Court in any event, it makes little sense to splinter this action with portions going to arbitration and the balance remaining in this Court. Such a solution seems especially ill-advised here, since it appears that the moving parties are not those primarily concerned and the same issues would have to be tried in two different places with the possibility of conflicting decisions.

The aforementioned combination of factors requires the denial of this motion.

C. *Additional Defendant Alex Aixala's Motion for Summary Judgment*

Additional defendant Aixala moves for summary judgment on the ground that he was merely an investor in the Corporation who played no role in any wrongful acts which might have occurred. Defendants' Rule 9(g) statement and affidavits in opposition sufficiently raise issues of fact concerning Aixala's liability for the acts of additional defendant Persky, allegedly Aixala's agent, and with regard to the nature and extent of Aixala's personal involvement in the events leading up to the execution of the Transfer Agreement to defeat a motion for summary judgment. This motion is denied.

Appendix C

D. *Defendants' Motion for Summary Judgment.*

Defendants have moved for summary judgment dismissing the complaint and in their favor on their counterclaims. They contend that the sale of the Partnership was in violation of N. Y. Partnership Law §98(1)(b) (McKinney 1948) and that it was fraudulent so that the Corporation does not have good title to the Buckley claim which it received from the Partnership; that the Partnership received the assignment of the churning claim in violation of the fiduciary duty owed to Gross, Bleich, and Donoghue; that the assignment was champertous; and that assuming the Buckley account was churned, the Partnership was a joint tortfeasor with Gross & Co. which, therefore, could not take an assignment of the claim. In addition to asserting these grounds as defenses, defendants also seek affirmative relief on those claims relating to the alleged illegality of the Transfer Agreement and the alleged fraudulent inducement by the Partnership of the assignment of the Buckley claim. Defendants also seek additional relief in their Third, Fifth, Sixth, Seventh and Eighth counterclaims which the Court cannot determine until such time as plaintiff establishes its claim so as to give defendants a right of set-off. See Section A, *supra* at pp. 3-4.

The Transfer Agreement in question was actually executed on February 11, 1971, although for reasons which do not concern the Court, it was dated December 30, 1970. Gross had given notice, effective September 30, 1970, of his withdrawal from the Partnership. On December 31, 1970, Bleich and Donoghue gave notices of withdrawal from the Partnership. Under the terms of §7.1(a) of the "Re-

stated Articles of Limited Partnership of Newburger, Loeb & Co. As Amended," Gross ceased to be a partner for all purposes as of the effective date of his withdrawal. Bleich and Donoghue, however, retained their status as limited partners for six months from the date of their notices of withdrawal pursuant to §7.1(b) of the Partnership Articles. As previously stated, none of them were parties to the Transfer Agreement and they stated their opposition to any such sale.

Section 98 of the N. Y. Partnership Law (McKinney 1948) provides that:

> (1) A general partner shall have all the rights and powers and be subject to all the restrictions and liabilities of a partner in a partnership without limited partners, except that without the written consent or ratification of the specific act by all the limited partners, a general partner or all of the general partners have no authority to
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> (b) Do any act which would make it impossible to carry on the ordinary business of the partnership.

It is undisputed that limited partners Bleich and Donoghue did not give their written consent to or thereafter ratify the Transfer Agreement. Plaintiff contends, however, that execution of the Transfer Agreement was not in violation of §98(1)(b). The Court, however, concludes that execution of the Transfer Agreement without the written consent of the limited partners was in violation of the statute. Even if there were a contrary provision in the Partnership Articles, an issue which the Court need not and does not decide, such a provision would violate §(1)(b)

and be invalid. This section, by its terms, is absolute and not subject to variation by agreement of the parties. Subsections (f) and (g) of §98 provide that they may be varied by including such variations from the law in the certificate filed with the State; such a right is not contained in subsections (a) through (e). This leads the Court to conclude that it was not the legislative intent to allow parties to a limited partnership to make variations from subsections (a) through (e). Furthermore, the policy underlying the law is the creation of limited liability for a class of persons who do not take part in the day-to-day management of a business. The law is not intended to divest them of participation in a decision to terminate a business in which they have a financial investment; the terms of the statute, in fact, strongly suggest the contrary.

Plaintiff's contention that it was the financial difficulties of the Partnership rather than the sale to the Corporation which made it impossible to carry on the ordinary business of the Partnership, simply seeks to avoid the real issue. The law makes provision for such a situation; the partners to the Transfer Agreement found such a solution to be economically untenable. They were not, however, empowered to go ahead with what they viewed as a more reasonable solution to their problem, when it, in effect, made it impossible to carry on the business of the Partnership without the consent of the limited partners. In light of the clear terms of the statute, this Court cannot consider the reasonableness *vel non* of the defendants' refusal to agree to the terms of the Transfer Agreement or the reasonableness of that Agreement. Defendants' right of refusal was absolute.

Appendix C

Although the execution of the Transfer Agreement was wrongful, rescission would be unwarranted within the context of this case. At the time of the execution of the Transfer Agreement, the only interest of Gross, Bleich, and Donoghue in the Partnership was the right to be paid certain sums of money. Damages, therefore are an adeguate remedy. The amount of injury, if any, that these defendants suffered as a result of the wrongful transfer must abide proof at trial.

In view of this determination that the Transfer Agreement violated N. Y. Partnership Law §98 (McKinney 1948), the Court need not decide if the making of the Agreement breached a fiduciary duty owed by the consenting partners [10] to Gross, Bleich, and Donoghue.

Defendants further contend that the assignment by Buckley of his churning claim to the Partnership was wrongfully induced by the defendants' partners and the partnership attorneys in violation of their fiduciary duties to defendants. The Buckley account was in a deficit position as of August 1966. In June 1970, the Partnership commenced an arbitration proceeding against Buckley to recover $289,782, the amount of the deficit. The Partnership had apparently sustained the loss as the "clearing" house on Buckley's account with Gross & Co. In his answer in the arbitration proceeding, Buckley asserted a counterclaim based upon alleged churning of his account. Defendants assert that the settlement agreement with Buckley was manipulated in such a way as to gain the assignment of the Buckley claim against the three defendants in order to pressure them into going along with the Transfer Agreement. The Partnership is not prohibited as a matter of

law from asserting a claim assigned to it by a third party against present or former members of the Partnership on a cause of action arising from those partners' alleged wrongs prior to their joining the Partnership. Partners can bring an equitable action for an accounting against co-partners for their alleged wrongful acts against their fellow partners during the period of partnership. N. Y. Partnership Law §44 (McKinney 1948). It thus follows that partners have a remedy against co-partners for wrongful acts committed prior to the formation of the partnership. Since an accounting would be inappropriate in such circumstances, the remedy would be an action at law for damages. If partners can bring such an action, there is no reason for prohibiting the Partnership to take an assignment of an action against individual partners if such an assignment is taken in good faith and does not breach the fiduciary duty owed to the partners being sued. The issue thus is that of the good faith of the Partnership and of Persky, the attorney representing it, in negotiations with Buckley. Good faith in this instance is a question of intent and motive. This is an issue which must be decided by the trier of fact after having an opportunity to observe the witnesses. Only where such observation is impossible are depositions an acceptable substitute. *Arnstein* v. *Porter,* 154 F. 2d 464, 469-70 (2d Cir. 1946); *Lorenz* v. *Watson,* 258 F. Supp. 724 (E. D. Pa. 1966).

Defendants' claim that the assignment of the Buckley claim was champertous is also inappropriate for summary judgment. Although there is some question whether the New York champerty statute, N. Y. Judiciary Law §489

(McKinney 1968), even applies to an assignment of a cause of action which is part of a settlement of a claim, the Court need not reach this issue at this time. There is a question of fact whether the Corporation acquired the Buckley claim as an incident of its purchase of the Partnership business, which would not be champertous, or if this claim was acquired in a separate transaction which *might have been* champertous.

Defendants further assert that on the facts as presented to the Court, there can be no finding of churning of the Buckley account with Gross & Co. during 1962-66. It is undisputed that there was considerable activity in the Buckley account. A finding of churning, however, requires additionally that the broker exercised control over the account. *E. g., Hecht* v. *Harris, Upham & Co.,* 283 F. Supp. 417 (N.D. Cal. 1968), *modified,* 430 F. 2d 1202 (9th Cir. 1970). Such a finding of control is not dependent on the account being formally labelled discretionary but is based rather on who in fact was making the decisions. *Id.* at 432-33. In other words, the issue of control is a question of fact to be determined upon the circumstances of each case. Two factors to be considered are the sophistication of the investor and whether all or most transactions in the account were made pursuant to the dealer's recommendation. *Id.* These are questions of fact to be resolved at trial, since they turn on the individual circumstances of each broker-customer relationship. Furthermore, the plaintiff has not yet had the opportunity to examine the registered representative of Gross & Co. with whom Buckley dealt, Charles R. Jordan. It is his motives and intent in connection with his handling of the Buckley account

which form the nub of this action. These too are questions of fact to be decided at trial. See *supra*, p. 12.

Defendants also contend that even if the Buckley churning claim is valid, the Corporation, as assignee, cannot assert it because its assignor, the Partnership, was a joint tortfeasor with Gross & Co. The Partnership's liability, if any, arises under §20 of the Security Exchange Act of 1934, 15 U.S.C. §78t(a). Even assuming *arguendo* that the Partnership was in a position of control over Gross & Co. or Jordan vis-a-vis the Buckley account, the Partnership would still not be liable if it "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." 15 U.S.C. §78t(a). Good faith, like motive or intent, is an issue of fact. *Arnstein* v. *Porter*, 154 F. 2d 464, 469-70 (2d Cir. 1946); *Lorenz* v. *Watson*, 154 F. Supp. 724 (E.D. Pa. 1966). In the instant case, plaintiff has sufficiently presented facts going to the issue of its good faith to withstand a motion for summary judgment on the ground that it is a joint trotfeasor.

Defendants' final contention is that the complaint, or at least the major part thereof, is barred by the statute of limitations. Plaintiff's third cause of action is predicated upon 15(c)(1) of the Securities Exchange Act of 1934, 15 U.S.C. §78(c)(1) and Rule 15c-1(7) promulgated thereunder. Section 29(b) of the 1934 Act, 15 U.S.C. §78cc(b) provides that an action to hold void a contract made in violation of §15(c) must be "brought within one year after the discovery that such sale or purchase involves such violation and within three years after such violation." Since plaintiff's third cause of action seeks damages, the issue is whether this limitation provision is controlling so as to bar this

claim. It has been held that a distinction between a tort and contract theory will not be determinative. So long as the activity allegedly engaged in is of the type which §15(c) seeks to prohibit, §15(c) applies whether the action is founded in contract or tort. *Goldenberg* v. *Bache & Company,* 270 F.2d 675 (5th Cir. 1959). A reading of the limitation provision of §29(b) to exclude actions for damages places a narrow, strained interpretation on the statute which the courts have not accepted. In *Geisman* v. *Bond & Goodwin,* 40 F. Supp. 876 (S.D.N.Y. 1941), the Court stated, in upholding a civil action for damages under §29(b), that

> . . . The 1938 amendment [the limitations provision] to Section 29(b) clearly contemplates that a civil suit against all of the defendants may be brought; it is not to be condemned because it is in form a proviso. I think, too, that the language of the section is sufficient not only for the cause of action for rescission (6th) but also for the companion causes of action for money damages (2d, 3d, and 4th). See Deckert v. Independence Corp., 311 U. S. 282, 61 S. Ct. 229, 85 L. Ed. 189 [1940]

See also, Maher v. *J.R. Williston & Beane, Inc.,* 280 F. Supp. 133 (S.D.N.Y. 1967). To hold that the self-same provision which created the right, albeit by implication, through the device of a statute of limitations did not apply to bar actions for damages brought after the running of the statute would be, to say the least, anomolous. Plaintiff's cause of action accrued at the latest as of the date of the last transaction in the Buckley account in August, 1966; since this action was not commenced until February 17, 1971, almost four and one-half years later, the third cause of action is barred by §29(b).

Appendix C

Since there is no federal limitations provision applicable to the other alleged securities violation causes of action, the Court must look to the analogus limitation period of the forum state. *Campbell* v. *City of Haverhill*, 155 U.S. 610 (1895); *Cope* v. *Anderson*, 311 U.S. 461, 463 (1947). As the parties agree, this is the New York six-year limitation period for constructive fraud. N. Y. C.P.L.R. §213:1. Thus, the alleged violations of the securities laws (except the third cause of action) based on transactions from February 17, 1965 to August, 1966, may clearly be maintained, as is conceded by defendants. Furthermore, the C.P.L.R., effective September 1, 1963, contains a transition provision, §218(b), which allows causes of action accrued but not barred as of the effective date to be governed by any prior limitation provision or that contained in the C.P.L.R., whichever is longer. Under the prior law, C.P.A. §53, the statute of limitations for constructive fraud was ten years; therefore, those parts of the complaint (except the third cause of action) based on transactions between April, 1962 and September 1, 1963, are also maintainable.

The period about which there remains a real question is that falling between September 1, 1963 and February 17, 1965. Although the parties have argued in terms of whether the alleged churning of the Buckley account constituted one continuing cause of action or separate causes of action accruing at the time of each trade in the account, the Court need not decide this issue at this time.

As stated in *Janigan* v. *Taylor*, 344 F. 2d 781, 784 (1st Cir. 1965),

> [*f*]*ederal law has long been established, . . . that where fraud is involved the cause of action is, so-to-speak, automatically concealed, and does not arise until discovery.* Bailey v. Glover, 1875, 21 Wall. 342, 22 L. Ed. 636; Traer v. Clews, 1885, 115 U.S. 528, 6 S. Ct. 155, 29 L. Ed. 467. Bailey v. Glover was said to apply equally to actions "at law" and "in equity" in tolling federal statutes of limitations. 21 Wall. at 349. *Holmberg* v. *Armbrecht,* 1946, 327 U.S. 392, 66 S. Ct. 582, 90 L. Ed. 743, extended the doctrine to toll a state statute of limitations where the cause of action was federal in origin and equitable. We are in considerable sympathy with Judge Friendly's opinion in Moviecolor Ltd. v. Eastman Kodak Co., 2 Cir., 1961, 288 F. 2d 80, 90 A.L.R. 2d 252, cert. den., 368 U. S. 821, 82 S. Ct. 39, 7 L. Ed. 2d 26, to the effect that the Holmberg decision should be applied to state statutes of limitation where the cause of action is federal in origin and cognizable solely in federal courts, whether the cause of action be regarded as "legal" or "equitable", concepts which have lost much of their meaning in federal practice. [Emphasis added.]

Thus, whether the Court applies the New York six-year limitation period for constructive fraud or the identical period for actual fraud, these causes of action are held to accrue as of the date when the fraud was discovered. or with reasonable diligence could have been discovered. *Bailey* v. *Glover,* 21 Wall. 342, 348 (1875). The New York rule that a constructive fraud action accrues on the date of commission is not adopted as federal law along with the time period. Such a result comports with the parallel situation in *Holmberg* v. *Armbrecht,* 327 U.S. 392 (1946), involving a New York statute of limitations under which fraud did not serve to toll the statute. The Court held that the federal equitable defense of fraud would be applied

along with the state limitations period. This result is also consistent with the approach of those portions of the securities acts which have self-contained statutes of limitations, Section 13 of the Securities Act of 1933, 15 U.S.C. §77m; and §§9(e), 18(c), and §29(b) of the Securities Exchange Act of 1934, 15 U.S.C. §§78i(e), 78r(c), 78cc(b), which contain discovery clauses.

The "Fourth Cause of Action" is based on alleged common law violations. Since this is a state law claim, the New York statute of limitations including the New York tolling provision applies. *Guaranty Trust Co.* v. *York*, 362 U.S. 99 (1945). As New York law holds that the statute of limitations for constructive fraud runs from the commission of the act, Practice Commentaries to C.P.L.R. §C213.9, those portions of this action based on transactions between April, 1962 and September 1, 1963 are barred under this theory. Although the series of transactions might be viewed as one continuing cause of action for the purpose of a federal securities law claim, an issue which the Court does not now decide, there is no basis for finding that they would be so viewed under New York law. The New York courts and the legislature in enacting the C.P.L.R. have shown themselves little disposed to extending the continuing treatment doctrine.

Summary judgment dismissing plaintiff's third cause of action and that portion of the fourth cause of action which relates to transactions between April, 1962 and September 1, 1963 is granted.

Settle order on notice.

Dated: October 16, 1973

S/ Robert J. Ward

U. S. D. J.

Supreme Court, U. S.
FILED
DEC 16 1977
MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-727

FINLEY, KUMBLE, WAGNER, HEINE, UNDERBERG & GRUTMAN, a Partnership (formerly known as Finley, Kumble, Underberg, Persky & Roth and Finley, Kumble, Heine, Underberg & Grutman),

Petitioner,

—against—

CHARLES GROSS, MABEL BLEICH, GROSS & CO., and JEANNE DONOGHUE,

Respondents.

BRIEF FOR RESPONDENTS IN OPPOSITION

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In the

Supreme Court of the United States

October Term, 1977

No. 77-727

Finley, Kumble, Wagner, Heine, Underberg & Grutman, a Partnership (formerly known as Finley, Kumble, Underberg, Persky & Roth and Finley, Kumble, Heine, Underberg & Grutman),

Petitioner,

—against—

Charles Gross, Mabel Bleich, Gross & Co., and Jeanne Donoghue,

Respondents.

BRIEF FOR RESPONDENTS IN OPPOSITION

Two petitions for certiorari have been filed in this case. The instant brief in opposition is written with respect to No. 77-727, filed by Finley, Kumble, Wagner, Heine, Underberg & Grutman (hereinafter Finley, Kumble), as petitioner, against four defendants, our clients, as respondents. We too have filed a petition for certiorari, No. 77-717, on behalf of one of these four clients, Charles Gross. It seems likely that the Court will consider these petitions together. To prevent confusion, we are avoiding the use of the terms "petitioner" and "respondent" wherever possible, and, instead, we refer to the parties by name.

It seems to us that Finley, Kumble's statement of the facts is inaccurate in overall aspect. The statement is de-

signed to give an impression that a simple federal churning claim was transformed by defendants into an enormous and complicated case, involving an enormous number of counterclaims, and involving large numbers of parties who were strangers to the simple federal churning claim.

> "It was the responsive pleadings which transmuted this simple federal case, involving four parties, into a cumbersome, protracted litigation of more than a dozen state claims involving two dozen non-diverse parties—most of whom had nothing to do with the original dispute." (Finley, Kumble, Petition, p. 7).

This picture is misleading. The "simple federal case" actually consisted of five causes of action stated in the complaint, three under federal law and two under state law. In the end, a total of 20 claims were pleaded by all parties, but eleven of these were pleaded by *plaintiff* and only nine by the defendants.

True, defendants asserted seven state counterclaims as ancillary to the complaint,[1] but it is rather naive to measure the complexity of the case by the number of claims asserted. Typically, many of the claims asserted by each party were merely variations of a theme, that is, restatement of substantially the same facts under different theories of law. Defendants' counterclaims follow this pattern. A reading of the District Court and Circuit Court opinions will quickly show[2] that the first seven counterclaims are all

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[1] Defendants' Ninth Counterclaim was based on federal law, namely, the anti-trust laws, and the Eighth Counterclaim was a parallel claim under state law.

[2] See portion of Circuit Court opinion at pp. 15a-16a.

based on the claim that the sale of the partnership assets and business, *including the sale of the churning claim to the plaintiff*, was ineffective because in violation of the New York Partnership Law, and in violation of fiduciary obligations. One reason why the number of ancillary counterclaims mounts up to seven is that there were three individual defendants and, in part, each had to assert his own claim based on the common set of facts. Thus, there is no validity to the idea that defendants inflated the case to abnormal proportions by asserting a tremendous number of counterclaims.

Finley, Kumble's statement of the facts also falls short of accuracy in describing the additional defendants on counterclaims as "strangers" to the case, "who had nothing to do with the original dispute." A reading of the opinions below shows that this contention is factually erroneous. Except for two individuals who were exculpated by the trial court, each of the new parties was found to have been a participant in a conspiracy to use the baseless churning claim to deprive defendants of their partnership rights and capital. Each of these new parties violated fiduciary obligations owed to the defendants in promulgating the baseless churning claim. Most of the additional parties were former partners of the defendants, who made a dishonest settlement with Buckley in order to create this churning claim, and then assigned the churning claim to a new corporation so it could bring suit as plaintiff. The assignment itself was made by these new parties without the proper authority required by Section 98 of the New York Partnership Law. The non-partner additional parties were employees and attorneys of the partnership, and also promoters of the new corporation, who participated in the conspiracy.

Finley, Kumble, itself was certainly no "stranger" to the churning claim. The idea to use this claim as a ploy in the conspiracy against defendants originated with a Finley, Kumble partner, Mr. Persky. Finley, Kumble, through Persky and others, then manipulated a bad faith settlement with Buckley so as to secure from him an assignment to the partnership of the baseless churning claim. Then Finley, Kumble issued a knowingly false opinion which enabled the churning claim, along with all the other assets of the Newburger, Loeb partnership, to be transferred from the partnership to the plaintiff corporation. Finally, Finley, Kumble were the lawyers who drafted the knowingly baseless complaint asserting the claim in the instant action.[3]

Under the circumstances, Finley, Kumble cannot fairly be described as a "stranger" to the churning claim. More accurately, Finley, Kumble should be described as father, mother, midwife, nurse and guardian of this illegitimate claim.

Finley, Kumble's statement of the facts is also misleading with regard to defendant Donoghue. Though Mrs. Donoghue was not named as a defendant in the complaint, she was a partner in defendant Gross & Co. The churning claim was used as an excuse not to pay her $75,000 admittedly owed as her partnership capital in Newburger, Loeb & Co. Accordingly, Mrs. Donoghue obtained leave of the Court to intervene, to participate in the defense against the churning claim, and to press her own claim for payment of her partnership interest. Judge Owen's decision permitting Mrs. Donoghue to intervene is pub-

[3] See summary of findings re Persky at 49a.

lished at 62 F.R.D. 397 (S.D.N.Y. 1974). To say that Mrs. Donoghue " . . . thrust herself into the action as a volunteer defendant" (Finley, Kumble Petition p. 9) does not quite give an accurate view of the record.

Finley, Kumble also falls short in its description of Mr. Gross's claim under the federal anti-trust laws. To say that this claim was "buried in the voluminous pleadings in this case" (Finley, Kumble Petition p. 10), is mere rhetoric. The claim was pleaded along with all the other claims and, indeed, a pendent claim under state law was also based on it. The claim was the subject of an unsuccessful motion to dismiss before Judge Ward in 1972, and was fully explored by discovery and fully tried. To say that the claim was dismissed with a word or two by the trial court is not to tell the whole story. The anti-trust claim was the subject of a very substantial cross-appeal, and the Court of Appeals opinion devoted four pages to it (52a-56a). Although the Court of Appeals upheld the dismissal of this claim by the trial court, it did so without prejudice to the reassertion of the related claim under state law in the state courts.

We must disagree with Finley, Kumble's statement that the counterclaims forced federal courts to decide novel questions of state law. Finley, Kumble phrases the state issues artfully to suggest novelty, but we do not think that the meaning of Section 98 of the Partnership Law presented a novel question. Nor do we think a novel question was presented by Finley, Kumble's argument that lawyers are immune from liability for participating with their clients in an illegal conspiracy. We think it very well settled that admission to the Bar does not constitute a

license to steal, or, as the Court of Appeals put it more politely:

> "... admission to the Bar does not create a license to act maliciously, fraudulently, or knowingly to tread upon the legal rights of others." (49a)

Thus, the actual facts are entirely inconsistent with every facet of Finley, Kumble's argument that the counterclaims transformed a "simple federal case" into an unwieldy monstrosity, casting a heavy burden on the federal judicial system. The decisions of the trial court and of the Court of Appeals are both inconsistent with Finley, Kumble's argument that counterclaims and additional parties were gratuitously injected into this case. The fact is that this case was complicated and delayed by Finley, Kumble and the other conspirators in order to carry out a threat made before the start of the litigation, that they would embroil the defendants in litigation for many years, and thus hold off payment of the sums owed to them (35a; 71a). The delaying tactics of the additional defendants on counterclaims were so extreme that at one point the District Court was forced to fine some of the additional defendants and their lawyers $750 for repeated failure to comply with orders directing answers to interrogatories.

We have gone to some length in criticizing Finley, Kumble's statement of the case because the relationship of the claims and counterclaims to one another is peculiarly central to issues involving ancillary and pendent jurisdiction. We respectfully suggest that a far better view of these relationships can be obtained from the decisions below than from the presentation in Finley, Kumble's petition. Further, we should point out that the allegations

made in our pleadings as to the connection between the complaint and counterclaims are not mere pleading allegations. All of these allegations were found to be true by the trial court, whose findings were upheld by the Court of Appeals. This is not a case where it can be argued that pleadings were engineered to give the color of a claim so as to provide a basis for jurisdiction. Finley, Kumble's reference to the "fertile mind of a pleader" (p. 20) has no application to this case.

It seems to us that the strategy underlying Finley, Kumble's presentation of the case is transparent. They have perceived this Court's deep concern that an undue expansion of federal jurisdiction will overburden the federal judicial system. They have sought to exploit this concern, as though prodding a raw nerve, by misdescribing this case as a bugbear of jurisdictional enlargement. In fact, this case represents the proper working of the doctrine of ancillary jurisdiction and rules of joinder to achieve their purpose of avoiding piecemeal litigation. The claims tried in this case certainly should have been tried together in the interest of justice between the parties and judicial economy.

ARGUMENT

Finley, Kumble's petition presents no legal issues that require determination by this Court.

A. *This case presents no novel or expanded interpretation of ancillary jurisdiction under Rule 13(a).*

Finley, Kumble's brief may create the impression that this Court has never decided the constitutionality of Rule 13(a). However, 51 years ago, in *Moore* v. *New York Cotton Exchange,* 270 U.S. 593 (1926), this Court decided that a Compulsory Counterclaim Rule was constitutional, and laid out a standard of application which has governed all the subsequent cases. True, *Moore* was decided before the enactment of Rule 13(a), but the decision in *Moore* was based on Equity Rule 30, which was identical with Rule 13(a) except for the addition of two words. Since the decision below falls well within the boundaries set by *Moore* for ancillary jurisdiction over counterclaims, no new or novel issue is now presented to this Court by this petition.

On page 15 of its petition, Finley, Kumble states that no court has ever previously held that a relationship of defenses to issues in the counterclaim satisfies the Compulsory Counterclaim Rule, except the Second Circuit decision in *Lesnick* v. *Public Industrial Corporation,* 144 F.2d 968 (2d Cir. 1944). That statement is flatly erroneous. Apparently, Finley, Kumble's research failed to turn up any of the following cases, each of which holds that a counterclaim is compulsory when issues which must be decided in connection with the defenses against the complaint also constitute a significant part of the counterclaims: *United Artists Corp.* v. *Masterpiece Productions,*

221 F.2d 213 (2d Cir. 1955); *TPO Incorporated* v. *Federal Deposit Insurance Corp.*, 487 F.2d 131 (3rd Cir. 1973); *The Kissell Company* v. *Farley*, 417 F.2d 1180 (7th Cir. 1969); *United States of America* v. *Haskins*, 505 F.2d 246 (9th Cir. 1974); *Sue & Sam Manufacturing Company* v. *B-L-S Construction Co.*, 538 F.2d 1048 (4th Cir. 1976).

Finley, Kumble's statement that *Lesnick* v. *Public Industrial Corporation*, 144 F.2d 968 (2d Cir. 1944), is the only prior case so holding, is particularly hard to understand in view of the fact that the same principle is set forth strongly and clearly in another Second Circuit decision which was fully argued in the briefs below, and which is cited at least seven times in the Circuit Court opinion herein: *United Artists Corporation* v. *Masterpiece Productions*, 221 F.2d 213 (2d Cir. 1955). See Circuit Court opinion below, pp. 27a-30a. The *United Artists* decision has twice been cited approvingly by this Court: *Baker* v. *Gold Seal Liquors*, 417 U.S. 467, 470 (1974) and *Moor* v. *County of Alameda*, 411 U.S. 693, 715 (1973). Circuit Courts have cited *United Artists* approvingly at least eleven times.

The entire purpose of the compulsory counterclaim doctrine is to avoid a multiplicity of litigation with regard to overlapping claims or issues. Inherently, material which is at the same time a basis for defense to the complaint and a portion of a counterclaim constitutes the strongest kind of "logical connection" or transactional overlap sought to be comprehended within the Rule. As we have shown, this conclusion has been voiced in many decisions. It has been denied in none.

Finley, Kumble's argument tries to sidestep the fact that the complaint itself had to allege that the new corporation *owned* the Buckley churning claims. This was an essential element of the complaint. No matter how grievously Buckley might have been churned in the period 1962-1966, a complaint based on this wrong could not be asserted by a corporation created in 1970 without some showing that it had acquired title to the claim. Paragraphs 4 and 5 of the complaint allege that Buckley assigned the churning claim to the Newburger Loeb Partnership, and that the Partnership assigned it to the corporation along with all the other partnership assets under the Transfer Agreement of February 11, 1971.

There was no way in which Gross, Bleich and Donoghue could have drafted an answer to the complaint without admitting or denying the validity of the two successive assignments alleged in Paragraphs 4 and 5. They believed that the Transfer Agreement of February 11, 1971, which included the assignment alleged in Paragraph 5 of the complaint, was invalid under § 98 of the Partnership Law, and invalid as well because brought about by fraudulent self-dealing. They had no choice but to raise these issues in the answer. The compulsory counterclaim rule consequently forced them to bring into this action all of their counterclaims based on these same facts and contentions.

Finley, Kumble seeks to avoid this organic connection between the complaint and the counterclaims by making an empty statement: that the corporation's allegation in the complaint that it owned the churning claim was merely a *"ritualistic one sentence allegation."* (Petition, p. 20, 2d footnote. Emphasis added). This astonishing argument

does not withstand one moment's contemplation. Plaintiff's allegation of title to the claim was vital. Without this allegation, as any legal neophyte would know, the complaint must be dismissed. By Finley, Kumble's logic, one could disregard as a mere "ritualistic one sentence allegation" the allegation of title in a trespass case, the allegation of marriage in a divorce case, or the allegation of residence in a federal case based on diversity of citizenship.

If the complaint had been tried alone, without the interposition of denials, defenses, or counterclaims relating to the validity of the assignments, a judgment in favor of plaintiff would have operated as *res judicata* against any subsequent actions by defendants based on such claims, for any judgment in favor of plaintiff would necessarily have involved a finding that the churning claim had lawfully been assigned to it under the Transfer Agreement.

The two District Court Judges and three Circuit Court Judges who considered the jurisdictional issues unanimously recognized that the Transfer Agreement was at the very heart of both the complaint and the counterclaims. Indeed, the opinions of the Trial Court and of the Circuit Court both stress that the churning claim was a ploy in the struggle over the Transfer Agreement, and that the issues raised in the counterclaims were inextricably intertwined with the churning claim (29a; 71a, 82a-83a).

The case squarely falls within the classic definition of compulsory counterclaim set forth fifty-one years ago in *Moore* v. *N.Y. Cotton Exchange*, 270 U.S. 593, 610:

> "'Transaction' is a word of flexible meaning. It may comprehend a series of many occurrences, depending not so much upon the immediateness of their connec-

> tion as upon their logical relationship. The refusal to furnish the quotations is one of the links in the chain which constitutes the transaction upon which appellant here bases its cause of action. It is an important part of the transaction constituting the subject-matter of the counterclaim. It is one circumstance without which neither party would have found it necessary to seek relief. *Essential facts alleged by appellant enter into and constitute in part the cause of action set forth in the counter-claim.* That they are not precisely identical, or that the counterclaim embraces additional allegations, as, for example, that appellant is unlawfully getting the quotations, does not matter. To hold otherwise would be to rob this branch of the rule [the compulsory counterclaim provision of Equity Rule 30] of all serviceable meaning, since the facts relied upon by the plaintiff rarely, if ever, are, in all particulars, the same as those constituting the defendant's counterclaim." (Emphasis added).

Thus, there is no substance to the argument made by Finley, Kumble that the decision below expands the scope of federal jurisdiction or goes beyond a host of prior decisions which have interpreted Rule 13(a) and its predecessor, Equity Rule 30.

The only jurisdictional error made by the Court of Appeals was its ruling (reversing the Trial Court) that jurisdiction did *not* exist over Mr. Gross's claim for conversion of his securities, pursuant to the same conspiracy under which the churning claim was created and under which all of the assets standing in the partnership name, including the churning claim, and including Mr. Gross's

securities, were unlawfully transferred to the corporate plaintiff. This matter is discussed in *our* petition for a Writ of Certiorari, No. 77-717.

B. *The right of the defendant to join additional parties as counterclaim defendants is well settled by rules and precedents approved by this Court.*

Finley, Kumble argues as though some novel question is presented by the fact that additional parties were brought into the case as defendants to the compulsory counterclaims. This argument overlooks the practical necessity and desirability of such joinder; overlooks long-standing joinder provisions embodied in Rules 19, 20 and 21 of the Federal Rules of Civil Procedure; and overlooks a long line of cases which approve the bringing in of new parties to defend against compulsory counterclaims. Finally, Finley, Kumble's presentation of this argument submerges the fact that as recently as 1973, this Court recognized these precedents approvingly in *Moor* v. *County of Alameda,* 411 U.S. 693.

Rule 13(h) provides that additional parties may be brought into the action to defend against counterclaims under the ordinary joinder rules set forth in Rules 19 and 20. Rule 13(h) reads as follows:

> "JOINDER OF ADDITIONAL PARTIES. Persons other than those made parties to the original action may be made parties to a counterclaim or cross-claim in accordance with the provisions of Rules 19 and 20."

Rule 19 provides that a new person shall be joined if ". . . complete relief cannot be accorded among those

already parties . . . ." Rule 19 is sometimes called the Compulsory Joinder Rule.

Rule 20 provides, in part, that all persons " . . . may be joined in one action as defendants if there is asserted against them jointly, severally, or in the alternative, any right to relief in respect of, or arising out of, the same transaction, occurrence, or series of transactions or occurrences, and if any question of law or fact common to all defendants will arise in the action." Rule 20 is sometimes called the Permissive Joinder Rule.

For a long time it has been recognized as clear that these rules operate together to enable new parties to be brought in as additional defendants on counterclaims when it is alleged that they are liable under the counterclaims along with plaintiff. Under the circumstances provided by Rule 19, the new parties *must* be joined as additional counterclaim defendants if feasible.

Rule 20(b) and Rule 21 wisely give the courts discretion to order separate trials, or to grant severances, or to order that certain parties be dropped, when the interests of justice or judicial economy so indicate. We think it highly significant that Finley, Kumble never made any motion under these rules for a separate trial, or for the severance of the case against it, or that it be dropped as a party.

Finley, Kumble's petition admits (p. 32) that several lower federal courts, like the court below, have held that a district court's ancillary jurisdiction extends to additional third parties whose presence is required for the adjudication of a compulsory counterclaim. Finley, Kumble

argues that this Court has never approved such authorities although they were mentioned in *Moor* v. *County of Alameda, supra.* We believe that, read in context, this Court's decision in *Moor* indicates unqualified approval of these authorities. This Court referred to the rule as "well-established" in the following portion of its decision in *Moor,* appearing at 411 U.S. 693, 714-715:

> "Moreover, the exercise of federal jurisdiction over claims against parties as to whom there exists no independent basis for federal jurisdiction finds substantial analogues in the joinder of new parties under the well-established doctrine of ancillary jurisdiction in the context of compulsory counterclaims under Fed Rules Civ Proc 13(a) and 13(h)[31] and in the context of third-party claims under Fed Rule Civ Proc 14(a).[32] "

The footnote references made by this Court in the above-quoted portion of its opinion, cite the following cases: *H.L. Peterson Co.* v. *Applewhite,* 383 F.2d 430, 433-434 (5th Cir. 1967); *Albright* v. *Gates,* 362 F.2d 928 (9th Cir. 1966); *Union Paving Co.* v. *Downer Corp.,* 276 F.2d 468, 471 (9th Cir. 1960); *United Artists Corp.* v. *Masterpiece Productions, Inc.,* 221 F.2d 213, 216-217 (2nd Cir. 1955); *Markus* v. *Dillinger,* 191 F. Supp. 732, 735 (E.D. Pa. 1961); cf. *Dewey* v. *West Fairmont Gas Coal Co.,* 123 U.S. 329 (1887); *Moore* v. *New York Cotton Exchange,* 270 U.S. 593 (1926); *Pennsylvania R. Co.* v. *Erie Ave. Warehouse Co.,* 302 F.2d 843, 844 (3rd Cir. 1962); *Southern Milling Co.* v. *United States,* 270 F.2d 80, 84 (5th Cir. 1959); *Dery* v. *Wyer,* 265 F.2d 804 (2nd Cir. 1959); *Waylander-Peterson Co.* v. *Great Northern R. Co.,* 201 F.2d 408, 415 (8th Cir. 1953).

Nor is there any merit to Finley, Kumble's reliance upon *Aldinger* v. *Howard,* 427 U.S. 1 (1976). That case is sharply distinguished from the instant case by at least three vital factors: (1) The decision in *Aldinger* was narrowly based upon Congressional intent that the Civil Rights Act not be applied against county governments; (2) *Aldinger* also rested on the fact that the new defendant was a person against whom " . . . no independent basis of federal jurisdiction exists." 427 U.S. 1, 2-3. At least thirteen times in the *Aldinger* decision the Court stressed the fact that the new party to be brought into the case was a party against whom no federal claim whatsoever existed, and who could not be brought into the action in any way except as a "pendent party." This factor does not apply to the instant case, for here independent federal jurisdiction existed over each and every additional defendant on counterclaims by virtue of the Ninth Counterclaim, which charged a violation of the federal anti-trust laws; (3) The facts and reasoning of *Aldinger* applied to a pendent claim asserted by a plaintiff, and not to a counterclaim, as in the instant case. A major consideration underlying the *Aldinger* decision was to guard against the ability of *plaintiffs'* attorneys, by artful maneuvering, to extend non-federal claims in the federal courts. This consideration is not present with regard to *defendants.* It is never the defendant who selects the forum. Defendant is brought into the federal courts by his adversary, the plaintiff. The rules of the federal courts frequently *compel* him to assert his counterclaim in that very case and forum. The nature of the counterclaim, as the courts have recognized, may require that additional parties be brought in for complete and economical adjudication.

The instant case illustrates these abstractions clearly. Defendants did not select the federal forum. They were brought into it pursuant to a conspiracy to destroy their partnership rights and property by means of a baseless federal churning claim. The plaintiff was only one of the conspirators and only one of the persons against whom the defendants had their claims. Rule 13(a) forced defendants to assert their counterclaims against the plaintiff in the federal action, and it would not be sensible, under any jurisprudential theory, to assert the counterclaims against the plaintiff in one action and the same counterclaims against the other conspirators in a separate state court action. The Federal Rules of Civil Procedure probably required defendants to bring in the other conspirators under the Compulsory Joinder Doctrine. At least, defendants were permitted to bring in the additional defendants against counterclaims under the Permissive Joinder Rule. Defendants' anti-trust claim against all of these conspirators was based on a federal statute, so that these additional defendants on counterclaims would be present as parties in the federal case, in any event.

Under these circumstances, we submit, *Aldinger* has no application to the instant case.

CONCLUSION

For the above reasons, and the grounds set forth in the opinion below, it is respectfully submitted that Finley, Kumble's petition for a writ of certiorari should be denied.

Dated: December 16, 1977

Respectfully submitted,

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IN THE

Supreme Court of the United States

October Term, 1977

No. 77-727

FINLEY, KUMBLE, WAGNER, HEINE, UNDERBERG & GRUTMAN, a Partnership (formerly known as Finley, Kumble, Underberg, Persky & Roth and Finley, Kumble, Heine, Underberg & Grutman),

Petitioner,

against

CHARLES GROSS, MABEL BLEICH, GROSS & CO., and JEANNE DONOGHUE,

Respondents.

REPLY BRIEF OF PETITIONER FINLEY, KUMBLE, WAGNER, HEINE, UNDERBERG & GRUTMAN

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REPLY BRIEF OF PETITIONER FINLEY, KUMBLE, WAGNER, HEINE, UNDERBERG & GRUTMAN

Petitioner, Finley, Kumble, Wagner, Heine, Underberg & Grutman ("Finley, Kumble"), submits this brief in reply to the brief of respondents Charles Gross, Mabel Bleich, Gross & Co., and Jeanne Donoghue (the "Gross faction") submitted in opposition to its petition for a writ of certiorari.

Preliminary Statement

The Gross faction does not dispute the significance of the jurisdictional issues addressed in our petition for a writ of certiorari. Instead, it urges that these issues are not raised by this case and that the courts below did nothing more than routinely to apply the existing law.

Such arguments, we submit, reflect the Gross faction's inability to understand what actually happened in the courts below; by the device of cleverly pleaded defenses, unrelated to the merits of the narrow federal claim set forth in the complaint, the Gross faction engineered a federal forum for a host of non-federal counterclaims involving serious and untested issues of New York law, and compelled the joinder of 19 counterclaim defendants, none of whom were connected with the merits of the narrow federal claim in the complaint. In short, by an apparently innocuous procedural move, the Gross faction turned this simple federal case into a complex state law action and, in the process, accomplished an enormous and unwarranted expansion of federal court jurisdiction.

A. The petition accurately sets forth the relevant facts.

The Gross faction's myopia with respect to the issues in this case extends to its view of the statement of facts contained in the petition. We shall not burden the Court with a detailed rebuttal of its counter-statement of facts. Rather, we shall limit our response to brief comments upon the principal points made in its brief.

1. The Gross faction disputes (Gross br. 2) our contention that:

> It was the responsive pleadings which transmuted this simple federal case, involving four parties, into a cumbersome, protracted litigation of more than a dozen state claims involving two dozen non-diverse parties—most of whom had nothing to do with the original dispute. (Petition 7).

Despite the Gross faction's protestations to the contrary, it is evident that the original churning claim was quickly overwhelmed and swallowed up by the Gross faction's state law counterclaims. These state law counterclaims became, in the words of the District Court, "the heart of the proceeding".* (B. 62a) They consumed nearly all of a six week trial and of an appeal which generated a record in excess of 6,000 pages.

2. The Gross faction also challenges our assertion that the additional defendants on the counterclaims, including Finley, Kumble, were strangers to the original churning claim. (Gross br. 3) That challenge is misplaced. The nineteen additional counterclaim defendants who were forced into federal court simply had no connection with the trading accounts of Mr. and Mrs. Buckley. And the Gross faction's argument to the effect that most of these defendants were ultimately found liable on the state law counterclaims is wholly irrelevant to the issue of whether those counterclaims belonged in federal court in the first place.

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* References are to the appendices in our petition for certiorari.

3. The Gross faction's contention that there was some basis to its claim under the antitrust laws borders on the frivolous. Both the District Court and the Second Circuit flatly rejected its contentions that the so-called antitrust claim constituted a basis for pendent or any other kind of jurisdiction over the state law counterclaims. (A. 33a-34a) It has nowhere disputed the correctness of this conclusion.

4. The Gross faction's suggestion that its counterclaims did not raise novel and important questions of state law (Gross br. 5-6) is plainly wrong. The Second Circuit noted that there were no cases directly on point with respect to the scope of a partner's fiduciary duty. (A. 48a) And, the Court did not refer in its opinion to a single New York case which even remotely clarifies, in the context of this case, the difficult question of the scope of an attorney's liability to third persons for actions taken in furtherance of his role as counsel. (A. 48a)

5. The Gross faction's contention that this is not a case in which pleadings were engineered to provide the courts below with a jurisdictional base (Gross br. 6-7) has a hollow ring. It is clear beyond cavil that the Gross faction's defenses, upon which it was permitted to build an elaborate structure of state law counterclaims, were totally ignored throughout the case. Those defenses, in short, were unnecessary to a disposition of the churning claim; indeed, both the District Court and the Second Circuit considered and resolved the merits of that claim without a single reference to the defenses.

B. The state law counterclaims are not compulsory.

We argued in our petition that the Second Circuit misinterpreted Rule 13(a) of the Federal Rules of Civil Procedure and thereby extended its ancillary jurisdiction far beyond permissible limits. The Court found that the Gross faction's counterclaims were compulsory under Rule 13(a), not because they met any of the relevant standards applied in such cases by other circuit courts* (*See, e.g., Pipeliners Local Union No. 798, Tulsa Okla.* v. *Ellerd,* 503 F.2d 1193, 1198 (10th Cir. 1974); *see also Sue & Sam Mfg. Co.* v. *B-L-S Constr. Co.,* 538 F.2d 1048 (4th Cir. 1976)), but because "there was a substantial overlap between the defendants' defenses and their . . . counterclaims." (A. 30a)

In defense of this decision, the Gross faction cites a series of cases which, it argues, stands for the proposition that a counterclaim can be found compulsory on the basis of its connection to a defense.** (Gross br. 8-9) Its reliance on these cases is seriously misplaced.

In each of the cases cited, the counterclaim which was held to be compulsory, the defense to which it related, and

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* As described in our Petition, these criteria include (1) common issues of law or fact; (2) common evidence, (3) res judicata effect and (4) logical connection, between the plaintiff's claim and the counterclaim. (Petition 16-17)

** These cases include *TPO Incorporated* v. *Federal Deposit Insurance Corp.,* 487 F.2d 131 (3rd Cir. 1973); *The Kissel Company* v. *Farley,* 417 F.2d 1180 (7th Cir. 1969); *United States of America* v. *Haskins,* 505 F.2d 246 (9th Cir. 1974); *Sue & Sam Mfg. Company* v. *B-L-S Construction Co.,* 538 F.2d 1048 (4th Cir. 1976). It also cites the Second Circuit decision in *United Artists Corp.* v. *Masterpiece Productions,* 221 F.2d 213 (2d Cir. 1955).

the initial claim set forth in the complaint involved a common set of legal and factual issues. Any link which existed between the counterclaim and the defense was irrelevant; it was the link between the claim in the complaint and the counterclaim which made the counterclaim compulsory. Thus, in accordance with the language of Rule 13(a), the counterclaim in each of these cases arose "out of the transaction or occurrence that is the *subject matter of the opposing party's claim.*" (Emphasis added.) Here, that simply is not the case.

The Gross faction also erroneously contends that its counterclaims did arise out of the same set of facts—the same "transaction or occurrence"—as the churning claim. But the "subject matter" of the original claim was alleged churning of the Buckley's trading accounts between 1962 and 1966. The counterclaims, on the other hand, involved entirely different matters based upon events which occurred almost five years later. Moreover, the assignment of the Buckley's churning claim to the plaintiff Corporation plainly was not the "subject matter" of the claim. That assignment was entirely peripheral to the merits of the churning claim and was wholly unconnected to the merits of the state law counterclaims.

C. The principles of *Aldinger* v. *Howard* are applicable in this case.

Our petition squarely raises the issue of whether ancillary jurisdiction can be asserted over third parties for whom there is no independent basis of federal jurisdiction. (Petition 30) And we urged that this case presents the Court with an appropriate opportunity to apply to the sub-

ject of ancillary jurisdiction the policies recently enunciated in *Aldinger* v. *Howard*, 427 U.S. 1 (1976).

The Gross faction disagrees, contending that the decision in *Moor* v. *County of Alameda*, 411 U.S. 693 (1973), foreclosed the issue. (Gross br. 14-15) That is plainly wrong. As discussed in our petition, this Court in *Moor* did not decide whether an independent basis of federal jurisdiction is necessary for either pendent or ancillary jurisdiction over third parties.

In addition, the Gross faction argues that *Aldinger* is inapplicable here because it was disposed of on narrow grounds. That argument, we suggest, misses the overriding theme of *Aldinger;* that in light of constitutional and statutory limitations on the scope of federal jurisdiction, courts should be exceedingly cautious about expansion of federal jurisdiction over third parties for whom there is no independent basis of jurisdiction.

Finally, the Gross faction argues that *Aldinger* is not applicable because it involved issues of pendent, not ancillary jurisdiction, and that it therefore must be read as preventing only plaintiffs from improperly seeking to extend the scope of federal jurisdiction. That argument is meritless. *Aldinger's* articulation of appropriate limits of federal judicial power is equally applicable to cases in which third parties are brought in by defendants. Surely, defendants can bootstrap non-federal claims into the federal courts just as cleverly as plaintiffs. Indeed, for a blatant example of such tactics, one need look no further than this case.

Conclusion

We respectfully submit that Finley Kumble's petition for a writ of certiorari should be granted.

Dated: December 28, 1977

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